Capital Markets That Help an Economy?

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Can the Abe administration build pro-growth capital markets?

The Abe administration took office on 26 September 2006. The new government is clearly putting a priority on economic growth, as evidenced by its slogan, "no fiscal reform without growth." This focus on economic growth was actually unveiled well before the Abe administration took office, both in the *Final Report* (subtitled "*A blueprint for vibrant integrated economic and fiscal reform*") put out by the Fiscal Reform Study Group within the LDP's Policy Research Council on 26 June and in the *Fundamental Principles of Economic Growth Strategy* announced by the Conference on Integrated Fiscal and Economic Reform[1] on 6 July 2006. In the *Basic Policies for Economic and Fiscal Management and Structural Reform 2006* (*Basic Policies 2006*) published on 7 July, "enhancing growth potential and international competitiveness" is positioned as one of the three priorities, alongside "advancing fiscal consolidation" and "achieving a safe, secure, flexible, and accommodating society." Beyond this focus on economic growth, the various policies included in all these reports are largely in line with the campaign pledges made by Abe in the LDP election. It may be accurate to say that the management of Japan's economic policy has been predicated on an Abe victory since the first half of 2006.

How will the new government approach the administration of financial and capital markets? Although the new administration is just getting started, if the reports noted above and Prime Minister Abe's campaign pledges are any indication, it appears likely that less importance will be placed on financial and capital markets measures within overall economic policy than was the case under the Koizumi administration.

Financial and capital market reform was the most critical component of broader structural reforms under Koizumi, as evidenced in the very first *Basic Policy* announced 26 June 2001, right after Koizumi formed his first cabinet. That policy paper made dealing with the nonperforming loan (NPL) problem the single most important issue, stating that the "disposition of nonperforming loans" was the "first step to reviving the economy." The paper proposed a policy of building a stable

[1] This was a new cooperative forum between the government and ruling coalition on cutting spending that was launched on 22 May 2006. Its members included Prime Minister Koizumi, Secretary-General Abe, Minister of Internal Affairs and Communications Takenaka, Minister of Finance Tanigaki, and Minister of Economy, Trade and Industry Nikai, officials that deal with the economy from the government side, as well as the LDP Secretary-General Takebe, Komeito's Chief Representative Kanzaki and Secretary-General Fuyushiba from the ruling coalition.

financial system "appropriate to the 21st century," and of invigorating securities markets, including by creating an environment conducive to investment in stocks by individuals, in order to smoothly transition to a system where direct finance has precedence. This was the beginning of the policy of encouraging a shift from savings to investments.

In response to *Basic Policy 2001*, the Financial Services Agency (FSA) launched structural reforms for securities markets and introduced a whole package of tax incentives for investing in securities. Serious progress was made in dealing with the problematic issue of NPL disposals after the Financial Reconstruction Program was launched on 30 October 2002.

The Basic Policy published in 2004, after the second Koizumi cabinet was formed, positioned the two-year period from April 2005 to March 2007 as a time for "enhancing the importance" [of finance]. It posited a program for enhancing the importance of finance that turned attention from NPL disposition to further strengthening Japan's position as a financial center through structural reform and revitalization of financial and securities markets, with an aim of new growth for the socioeconomic system by offering a high level (based on global comparisons) of financial services that meet users' needs. This kept the administration of financial and capital markets at the forefront of policy.

In response to this program to raise the importance of finance in the *Basic Policy 2004*, the FSA announced a financial reform program on 24 December 2004, under which it pushed forward reforms aimed at better protecting users while making markets easier for them to use. The fruits of these efforts include the passage of the *Financial Instruments and Exchange Law*, as well as progress in dealing with such issues as nonpayment of non-life insurance benefits and problems in the lending industry.

Although this financial reform program is slated to end in several months, there has been no discussion of any new, follow-on policy packages related to the administration of financial and capital markets. The LDP Fiscal Reform Study Group's final report, the *Fundamental Principles of Economic Growth Strategy*, and the measures related to financial and capital markets contained in the Basic Policy 2006 include a large number of issues that either are already being dealt with or are nothing more than fragmented or obscure ideas. To put it more bluntly, it appears that a scenario of fiscal reform through economic growth is taken as a given, and thus any existing measures or abstract ideas that are even remotely related to that are now being dismissed as incidental. Even if a focus on economic growth is still alive, there no longer seems to be any energy directed at addressing the question of what form Japan's financial system must take to achieve that growth, and systematic discussion of the policies that are required looks to have fallen by the wayside. It appears that the administration of financial and capital markets is no longer one of the core elements of policy.

To the extent that the alleviation of fiscal problems through economic growth is posited as the new challenge over the next ten years and a key element of the Basic

Policy 2006, it follows that there is a need to directly engage the question of how to build financial and capital markets that contribute to economic growth.

Financial markets are at root a mechanism to facilitate economic growth. For the past 15 years in Japan, however, financial markets have would up suppressing economic growth and bringing economic instability, as symbolized by the NPL problem. Now that the NPL problem has run its course, we seem to have finally reached a point where financial markets can start contributing to economic growth. It is time to introduce to financial markets institutional mechanisms that promote economic growth, as well as to rethink those mechanisms that have wound up hindering growth.

As will be shown below, there is now growing concern and debate in the US over a loss of competitiveness of US capital markets and a declining ability for capital formation within US industry. Even in the US, which is considered to have by far the largest and most advanced financial center, close attention is paid to maintaining and strengthening the competitiveness of its financial and capital markets, and measures to achieve that are considered on a regular basis. It can hardly be viewed as a positive that after ten years have passed since former Prime Minister Hashimoto proposed "Big Bang" financial reforms for Japan on 11 November 1996, the goal of Japan, which is just now approaching what could be termed an economically sound condition, becoming a financial center that rivals New York and London is nothing more than wishful thinking.

US worries over decline in the competitiveness of its financial and capital markets

The US passed corporate reform legislation (the *Sarbanes-Oxley Act*; Sarbox) in July 2002 in the wake of a series of corporate scandals beginning with Enron and WorldCom, and from the outset the huge increase in the cost of corporate compliance resulting from the strengthened internal controls prescribed in Section 404 of that act have been viewed as a problem. This criticism was only sporadic back when the public outcry over corporate scandals remained strong, but has gradually come more out in the open since then, and is now discussed both in congress and within administrative bodies. The application of Section 404 to other than large corporations has repeatedly been postponed.

In April 2005, the SEC sponsored a Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions, where it was pointed out that the administration of internal controls generated substantial costs and that these costs had the potential of becoming excessively large, especially for second-tier and smaller companies.

Prior to this in March 2005, the SEC established an Advisory Committee on Smaller Public Companies to look at securities regulations as they relate to smaller

US companies, and the committee issued a final report on 23 April 2006[2]. The report contained a broad range of recommendations that addressed more than just internal controls in smaller companies, including disclosure mechanisms, accounting standards, and rules on financial reporting.

The committee noted that there is reason for concern that the high cost of complying with Section 404 and other provisions of Sarbox could cause domestic issuers to go private and foreign issuers to avoid listing their stock in the US. These same concerns have often been voiced outside of this committee, as well. For example, John Thain, Chairman of the New York Stock Exchange, criticized Sarbox[3] by noting, "Last year, 23 of the 25 largest IPOs listed their shares outside of the US, and this year nine out of the ten largest did so," a statement that wound up being widely quoted. There is a rising awareness in the US that stronger regulations have lowered the competitiveness of US capital markets while harming US innovation and capital formation and even damaging the US economy.

Some also argue that it is unknown to what extent a post-Enron tightening of regulations is to blame for this. For example, although it is true that Chinese corporations have shown a tendency to steer clear of US capital markets, it has been argued that this stems more from a desire to avoid securities-related litigation than from a desire to escape from the cost of internal controls.

As for the claim that the increased cost of listing shares has given public companies an incentive to go private, there has clearly been an increase in the number of companies going private over the past few years compared with 2003, as shown in Figure 1. If it is the number of such cases that is the issue, however, it is worth noting that the numbers were considerably higher in 1999 and 2000. Furthermore, the average size of companies that go private has increased over the past several years, but as some have pointed out, if it was the rising cost of regulation that was causing this move to private equity, you would expect an increase in the number of small firms going through the process.[4]

2 See Kei Kodachi, *Kigyo Kibou ni Oujita Shoukenhou Kisei wo Mosaku suru Beikoku* (US Gropes for Securities Regulation Commensurate with Corporate Size), in the Summer 2006 issue of the Japanese edition of the *Nomura Capital Markets Review* (in Japanese).

3 See Jenny Anderson and Heather Timmons, "NYSE Group Reaches Deal to Acquire Euronext," in the *New York Times*, June 2, 2006.

4 From discussions at a Brooking Institution -- Nomura Institute of Capital Markets Research conference on capital markets, sponsored by the Tokyo Club Foundation for Global Studies (12 September 2006). The counterargument could possibly be made that, because Section 404 has yet to be applied to small companies, the smaller companies are the only ones that are unaffected.

Figure 1 Stocks going private in US

Year	Number of estates	Average size($ million)
1995	6	339.03
1996	10	142.99
1997	26	231.83
1998	19	171.76
1999	40	238.85
2000	43	204.70
2001	19	303.58
2002	18	331.88
2003	15	138.64
2004	21	838.70
2005	28	740.96

Note: Average size expressed in 2005 prices.
Source: Thomas Boulton, Kenneth Lehn, Steven Segal "The Rise of the Private Equity Market", mimeo

Thus, although there is room for arguments on both sides concerning the extent of the problem and its cause, it is well worth noting the vigor of debate, over not only the impact of tighter regulation over the past few years but also the contribution to the competitiveness of US capital markets and to the capital formation process.

Particularly worth noting in this context are the Commission on the Regulation of US Capital Markets in the 21st Century and the Committee on Capital Markets Regulation.

The former, established by the US Chamber of Commerce in February 2006 and working under the idea that modernization of capital markets is essential for the US to remain the world's greatest economic superpower[5], is currently debating how to make US capital markets more competitive, promote the supply of capital for growth and job creation at US companies, protect investors, and promote savings. A report issued when the commission was established criticized Section 404 of Sarbox and addressed a wide range of problems, including the nature of auditing firms and the regulation and oversight of financial corporations (including the problem of separate federal and state regulations), the cost of litigation, and the short-term orientation of management (to be discussed below), arguing that the system was in crisis.[6]

The commission also conducted town hall meetings in major US cities in September-October 2006, and plans to propose reforms in February 2007 based on its discussions until then.

The Committee on Capital Markets Regulation, which is co-chaired by former presidential economic advisor Glen Hubbard and former Goldman Sachs president John Thornton, has Harvard Law School professor Hal Scott serving as the Director of the Committee, and includes a number of other prominent members, was formed in

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5 From a US Chamber of Commerce press release dated 13 February 2006.

6 US Chamber of Commerce, *Capital Markets, Corporate Governance, and the Future of the U.S. Economy*, February 2006

September 2006[7]. A favorable comment made by Treasury Secretary Henry Paulson when the Committee was formed gave it some press. The Committee issued an interim report on November 30th, 2006.

Disputes attracting attention

As the debates described above have shown, there have been lively discussions of not only the *Sarbanes Oxley Act* of 2002 but also of a variety of issues related to US capital markets, and we introduce several of those below; specifically problems related to analysts, short-term thinking, governance, and the introduction of SEC regulations.

1) Analyst reports

In the US, the need for sell-side analysts to support their company's underwriting business and their output of biased research was seen as a problem, and this led to a tightening of regulations affecting analysts. Having a particularly large impact on analysts was the prohibition of compensatory payments to sell-side analysts by the investment banking divisions brought by the implementation of the NASD rule and the NYSE rule, both of which reflected a wide-ranging settlement reached on 28 April 2003.

In addition to causing a decline in the number of sell-side analysts and their compensation, it encouraged the outsourcing of research to India and elsewhere, and created a problem by decreasing analyst coverage.[8] As shown in Figure 2, about 26% of companies have no analyst coverage at all, while about 20% are only covered by one to two analysts. Research has begun to concentrate on momentum stocks and stocks popular among institutional investors, and there has been a shift toward such services as providing trading ideas to hedge funds. There has been a decline in the quantity of sell-side research reports that are provided to retail investors, who now must increasingly rely on company information from expert networks (including blogs by people who specialize in specific companies or industries) and other information that is available for free online but is not necessarily of high quality.

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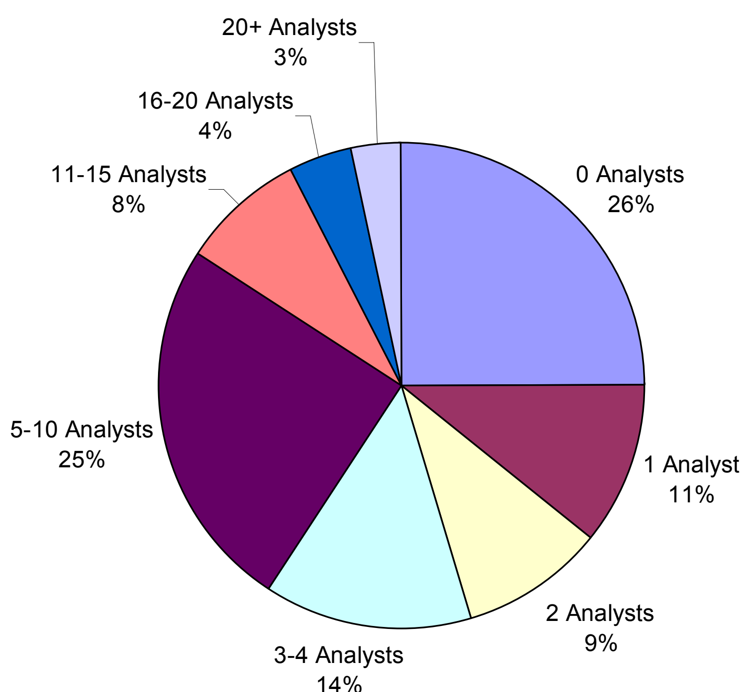
7 See Alan Murray, "Panel's Mission: Easing Capital-Market Rules," *Wall Street Journal*, September 12, 2006.

8 Regarding these changes, see the joint report by NASD and the NYSE, *On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules*, December 2005, and Yasuyuki Fuchita and Robert Litan, editors, *Financial Gatekeepers*, Brookings Institution Press and the Nomura Institute of Capital Markets Research, 2006.

Figure 2 Analyst coverage of public corporations in the US



Note: Public corporations classified by the number of analysts that cover their stock.
Source: Aggregated by IRN using Factset Data Systems, as of September 2006.

The source of compensation for sell-side analysts has traditionally been investment banking divisions and brokerage trading divisions, but funds from the former have been cut off as a result of the comprehensive settlement, while profit margins from trading have also been on the decline, in part owing to decimalization, whereby the increment for quoting prices has been reduced from 1/4 or 1/8 of a unit to 0.1. Brokerage commissions have also long been in a declining trend. As a result, the old arrangements underpinning sell-side analysts are becoming a relic of the past.

There is concern that the resulting decline in analyst coverage will lead to lower liquidity for mid- and small-cap stocks and higher costs of capital, and ultimately hinder capital formation in the US.

A joint report from the NYSE and NASD, both of which recognize these problems and have looked at revising self-regulatory rules for analysts, ultimately failed to come up with a proposal to eliminate these problems at their core, stopping only at calling for somewhat technical revisions, including a revision to disclosures and a shortening of the quiet period.[9]

Now that the traditional business model for sell-side analysts has become structurally more difficult to use, the issuer is being looked at as a potential new source of funding for this research. If a company were to directly pay a specific analyst to write a report there would of course be doubts over the objectivity of that

[9] Based on the arguments made in the Joint Report referred to in footnote 8, both NASD and NYSE submitted proposed changes to their self-regulatory rules to the SEC in September 2009.

report, so the concept is to involve an intermediary institution, which would pay two to three analysts to write a report every quarter for a two or three-year period. Analysts would work under contract with this intermediary, which would select the appropriate analysts based on their industry specialty. These analysts would be affiliated with either the research divisions of securities companies or independent research houses. The intermediary institution would confirm that the analysts are writing a quarterly report of a given length per their contract and would also assess the quality of their research using a third-party agency.

Although there is a question as to whether issuers will have an incentive to fund this arrangement, there is evidence that it will lead to greater analyst coverage, higher liquidity, and lower capital costs. As some observers point out, by shifting a portion of funds currently spent on IR activities, issuers would be able to provide investors with more objective and valuable information, which in turn would have a greater impact on the share price.

A portion of the money paid by issuers to investment banks when issuing securities could instead be paid to the intermediary institution, which would use the funds to enter into two to three year contracts to write research reports with analysts from several companies. Assuming that a portion of the money paid to investment banks has been used to compensate the analysts, it would be a rational decision for the issuer to try to use that money to secure analyst coverage on their own after issuance.

The old system has been criticized by the issuer, since once the securities firm that underwrites the issue receives its underwriting fee, it may not continue to write research on a consistent basis. By implementing the arrangement described above, issuers can secure coverage from analysts at several companies for several years. The leading investment banks are now said to be interested in going to such a business model, because the model creates another selling point for the large investment banks: an assurance of continued research coverage after issuance by multiple high-quality analysts outside of their firm. In this case, the underwriting investment bank pays a portion of its underwriting fees to the intermediary institution, which in turn secures other research providers (either independent analysts or sell-side analysts from other securities houses).

There are currently two such intermediary institutions, the Independent Research Network (IRN) and the National Research Exchange (NRE). IRN is a 50/50 joint venture between NASDAQ and Reuters, while NRE was launched independently by a NASDAQ executive. Both are at the start-up stage with less than two years in operation, making it difficult to say whether they will succeed. If these trials do no go well, however, the structurally difficult situation that sell-side analysts have fallen into may continue.

2) Short-termism

The debate over structural problems with US capital markets has also focused on the problem of short-term thinking. In the US in the early 1990s, many observers argued that the decline in US productivity was a consequence of the short-term thinking (short-termism) and myopia of management[10], and commentators like Michael Porter and Lester Thurow argued that the long-term oriented corporate management achieved by Japan's keiretsu through cross-shareholdings was of valuable reference.[11] Subsequent to that, the US economy underwent a strong recovery on productivity improvements, without ever trying to copy Japan's cross-shareholding system.

Criticism of short-termism has recently resurfaced in the US.[12] In a survey of 400 corporate CFOs, 80% of respondents said that R&D and other discretionary spending were cut in order to meet short-term earnings targets.[13]

The frequent occurrence of corporate accounting scandals is probably one reason why short-termism has reemerged as an issue. This is because the widespread use of stock options has made corporate management even more concerned over short-term earnings than before, thereby making management more prone to engaging in accounting trickery.

Another possible factor is that the current composition of investors is more short-term oriented than it used to be. That is, the shift to defined-contribution pension plans has made investment trusts important market players, and turnover at investment trusts tends to be higher than at traditional pension funds. Another big difference with the past is that hedge funds now have a considerably greater influence on the market. Although there are some hedge funds that focus on long-term value, there are many that trade frequently to ensure they do not miss out on any profit opportunities. Another probable reason for the greater short-term orientation of investors overall is the online trading activity of some individual day traders. As shown in Figure 3, trading turnover on the NYSE has increased sharply over the past few years.

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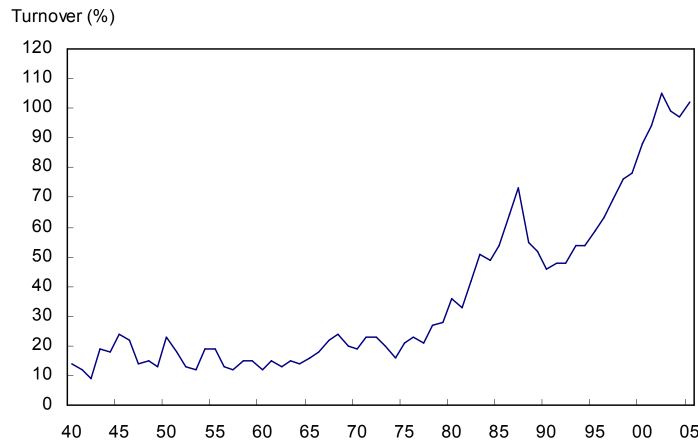
[10] See, for example, Michael T. Jacobs, *Short-term America: The Causes and Cures of Our Business Myopia*, Harvard Business School Press, 1991.

[11] Michael Porter, *Capital Choices: Changing the Way America Invests in Industry, A Research Report Presented to the Council on Competitiveness and Co-sponsored by the Harvard Business School*, 1992 and Lester Thurow, *Head to Head: The Coming Economic Battle among Japan, Europe, and America*, William Morrow and Company, 1992.

[12] See, for example, a speech given at a Business Roundtable Corporate Governance Forum by the chairman of the SEC at the time, William Donaldson, entitled "The New Environment in Corporate Governance: Taking Stock and Looking Ahead," September 10, 2003. According to "Mapping the Terrain" a survey taken in 2004 by the Business Roundtable Institute for Corporate Ethics, one of the most pressing ethical issues facing the CEOs of the biggest corporations in the US is how to respond to short-term investor expectations.

[13] John R. Graham, Campbell R. Harvey and Shivaram Rajgopal, "The Economic Implications of Corporate Financial Reporting," *Journal of Accounting and Economics*, vol. 40, 2005.

Figure 3 Trading turnover on the NYSE (1940--2005)



Source: *NYSE Fact Book*

When the short-termism of management was identified as a problem in the early 1990s, pressure from the short-term orientation of institutional investors and analysts was seen as one of the causes, and thus it is possible that the problem is even more serious today.

One recent proposal to address short-termism can be found in *Breaking the Short-Term Cycle*, a report issued in July 2006 jointly by the Business Roundtable Institute for Corporate Ethics and the CFA Center for Financial Market Integrity, which is a sub-organization to the CFA Institute, an organization that certifies investment professionals.[14]

This report is based on findings from the symposium series on short-termism started by the two authoring organizations in September 2005. The symposium, which had issuers, analysts, fund managers (including hedge funds), pension funds, and representatives from individual investor organizations as participants, addressed the problem of short-termism, and unanimously reached the conclusion that short-termism destroyed long-term value, reduced market efficiency, lowered investment returns, and obstructed efforts to strengthen corporate governance.

The same report went on to make five main recommendations: reform earnings guidance practices; restructure compensation for corporate executives and asset managers; demonstrate leadership in shifting focus; improve communications and transparency; and promote education.

Several months have passed since the report was published, and the CFA Center has continued to give briefings on the contents of the report to corporations and investors, while also working on a project to propose a model for quarterly earnings announcements that, unlike the current earnings guidance, focuses also on long-term value drivers.

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[14] CFA Center for Financial Market Integrity / Business Roundtable Institute for Corporate Ethics, *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value*, July 2006.

3) Governance

The short-termism described above essentially argues that corporate management is forced into short-term thinking because pension funds, asset managers, and analysts have a short-term orientation. Nevertheless, if investors really had that much impact on corporate management, then it would make sense that various problems with corporate management could be easily corrected merely by better leveraging market discipline and shareholder governance, rather than by having to rely on costly regulations.

In fact, one opinion seems to be that traditional institutional shareholder activism can produce only limited results.[15] That is, there is a cost to institutional investors of monitoring the activity of individual corporations. Even when institutional investors apply pressure jointly, it costs time and money for them to coordinate their efforts. Furthermore, even if enterprise value is increased by investor activism, there is a free-riding problem in which investors who did not participate in the activism benefit from it. There is also the fear that any major involvement in management by institutional investors could lead to insider trading. Another problem for many institutional investors is that it is difficult to become a large enough shareholder to exert influence on a particular company while still satisfying clients' need for investment diversification.[16]

Because of this, although there are examples of some institutional investors succeeding in their attempt to correct corporate management by exercising their voting rights, making shareholder proposals, publishing a list of companies with performance problems, or leading class action lawsuits against corporate malfeasance, they generally are unable to exert real influence.

Investors can reach a consensus and have an adverse impact on management in regards to immediate quarterly earnings, which are closely tied to the short-term share price, but it may be difficult for them to achieve a consensus of opinion regarding other corporate activity.

Partnoy and Thomas, while noting that such traditional activism by institutional investors has not been very effective, also point out that there is reason to believe that recent activism by hedge funds may be having a large impact. That is, there are various types of hedge funds, including some that pursue market neutral positions and others that trade to exploit macroeconomic distortions, but those that became actively involved in the management of individual corporations have not stood out in the past.

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[15] Frank Partnoy and Randall Thomas, "Gap Filling, Hedge Funds, and Financial Innovation", http://www.brook.edu/es/ research/projects/t5/2006tc_partnoy.pdf. This paper was published at a Brookings Institution -- Nomura Institute of Capital Markets Research conference on capital markets, sponsored by the Tokyo Club Foundation for Global Studies (12 September 2006).

[16] As a result of the requirement for disclosures of when mutual funds exercise voting rights, there has recently been some empirical research published on how mutual funds have exercised their voting rights, and the results are that in nearly all cases, the mutual funds have supported management proposals as is. See Tom Lauricella and Kaja Whitehouse, "No Secrets: How Funds Vote Your Shares," *Wall Street Journal*, October 3, 2006 and Roben Farzad, "Fidelity's Divided Loyalties," *Business Week*, October 16, 2006.

As the hedge fund market has grown in recent years, however, we have started to see hedge funds that have become known for their shareholder activism and focus on acquisitions.

Nevertheless, hedge fund interest in corporate management may be aimed at maximizing short-term profits, and there is a risk that this could exacerbate the short-termism described above. Hedge funds will also take a large position in a corporation to exert influence, while at the same time hedging the economic risk of owning that company's shares by entering into an equity swap agreement with an investment bank. This means that in some cases hedge funds are able to exercise voting rights at a lower effective cost than the typical investor who owns only a long position. Hedge fund activism brings up a new problem in regards to how governance should be viewed.

4) The implementation of SEC regulations

If the expectations from market discipline and shareholder governance are not that high, it remains important to directly intervene by legislating rules on corporate behavior and by structuring rules so as to make market discipline and governance more effective. One example of the latter is the recent strengthening of disclosure requirements for executive compensation, the first revision of those rules in 14 years. Nevertheless, as seen in the criticism of Sarbox, there has been growing criticism of the recently introduced rules related to financial and capital markets.

The issue of costs associated with Section 404 is not the only problem with Sarbox, which mandated the establishment of the Public Company Accounting Oversight Board (PCAOB). A law suit was filed by auditing firms and others in February 2006 maintaining that the PCAOB is unconstitutional because the government and congress lack the power to appoint board members, despite the organization being a de facto government institution.

Some SEC rules introduced over the past few years have also come under heavy criticism. In one case, a federal court rules that SEC regulations requiring hedge funds to register were invalid because the SEC had arbitrarily redefined the term "Customer". In response to mutual fund fraud, regulations were passed in June 2003 that strengthened the oversight of mutual funds by outside directors, but in June 2005 a federal court overturned the regulations, saying that there was insufficient analysis and consideration of alternatives in regards to the regulations' costs in terms of competition, efficiency, and capital formation. William Donaldson, the SEC chairman at the time, readopted the same regulations at the end of June 2005, right before he resigned, but a federal court once again overturned the regulations in April 2006.

In regards to this, former SEC chairman Harvey Pitt complained about the regulatory cost and the lack of economic analysis.[17] He asked, for example, whether there was any proof that increasing the weighting of outside directors and having an outside director serve as chairman were truly effective ways to solve the problems

[17] Harvey L Pitt, "Over-Lawyered at the SEC," *Wall Street Journal*, July 26, 2006.

identified at mutual funds. He questioned whether sufficient thought had gone into considering whether it made sense to spend limited SEC resources to protect hedge fund investors, even though the economic nature of hedge funds dictates that they are a product meant for sophisticated investors. Pitt also pointed out that the SEC's role was not only to protect investors, but also to promote efficiency, innovation, and capital formation. Other experts in the field have expressed nearly the same criticisms.[18]

As to whether sufficient consideration may not have been given to regulatory costs, the above noted final report from the Advisory Committee on Smaller Public Companies addressing problems with Section 404 of Sarbox made the same point, and there may be room for improvement not only in the SEC's rulemaking process, but also in congress' legislative process.

Suggestions for Japan

On 1 August 2006, Henry Paulson chose Columbia University in New York as the forum for his first public speech as Treasury Secretary. As to his reason for choosing New York, Secretary Paulson said, "This city is unquestionably the world's financial capital. New York is home to financial institutions that are leaders in the U.S. and in every major market around the globe, and that is saying something! I also chose to come to New York because I know from experience that the solutions to our nation's challenges are not always found in Washington."

After remarking in his speech that corrective measures to address corporate scandals like Enron and WorldCom and increase investor confidence played a role in the US economic recovery, he went on to say, "Often the pendulum swings too far, and we need to go through a period of readjustment. ... The challenge before us now is how to achieve the right regulatory balance to allow us to be competitive in today's world while guarding against the recurrence of past abuses."

It is difficult to establish the optimal regulatory framework at the outset, and the regulations that are needed will change along with changes in the times and in the external environment. What therefore becomes important is to maintain an attitude of tolerating healthy trial and error while flexibly reviewing regulations. There is no denying that the introduction of regulations in Japan has been strongly influenced by the regulations introduced in the US, especially since the Enron scandal. If the US is going to review its assorted regulations, there is no reason why Japan should hesitate to reassess the nature of its regulations, both existing and pending.

It is also important moving forward to incorporate an adequate cost-benefit analysis of regulations into the basic rulemaking process, as has been pointed out in the US. Although the specifics have been criticized, in the US when the SEC proposes

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[18] Ronald A. Cass and Henry G. Manne, "SEC à la Donaldson," *Wall Street Journal*, July 1, 2005.

rules, a cost-benefit analysis of the regulations is always performed. In Japan's case, there is probably room to reconsider the fact that such analysis is not expressly built in to the policy-making process.

Of course, the specific problems being debated in the US that are highlighted in this paper cannot be transposed to Japan fully intact. For example, a number of securities firms in Japan are already working to add analysts and expand coverage of small- and mid-cap stocks. Nevertheless, the supply of analysts that is insufficient to meet the demand may be a more serious problem in Japan than it is in the US.[19] Accordingly, a mechanism to encourage those companies with insufficient coverage to pay for the research may also be effective in Japan, and the US experience with IRN and NRE would probably be instructive in this regard.

As for short-termism, quarterly earnings guidance is not that prominent in Japan, where the norm has been for companies to announce earnings forecasts for the fiscal year and the interim period. Even this problem probably bears watching moving forward, however, given that the earnings guidance mentality has begun to take root in some quarters in step with the rising market presence of nonresident investors and the stepped up use of quarterly reporting. While cross-shareholdings have declined, both hedge funds and day traders are having a greater impact than before, and this is causing turnover to increase, a point in common with the US. Another interesting fact that has been pointed out is that institutional investors in Japan actually behave on a shorter time-frame than their counterparts in the US and Germany.[20]

While those trends in the US that are of valuable reference should be studied closely, it is of course necessary at the same time to deal with issues specific to Japan. The most pressing of these is the shift from savings to investments. It will be a problem if this shift, proposed as a goal in the Basic Policies 2001, is not actively championed by the new administration, despite its not having been attained yet.

The problems with Japan's financial and capital markets do not seem to be the type that can be solved merely by ensuring that the NPL problem is initially taken care of and share prices turn around. Unless this shift from savings to investment can be achieved, risks will continue to be disproportionately high in the banking sector, and it is hardly the case that banks have set interest rates at a level that justifies this risk. As noted earlier, the Basic Policies 2001 proposed building a stable financial system "appropriate to the 21st century," and this does not seem to have been achieved thus far.

Financial and capital markets throughout the globe, including those in the US, are committed to maintaining and improving their competitive position. The new administration needs to bear firmly in mind that Japan, while learning from global trends, must continue dealing soberly with the structural problems in its own markets.

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[19] See *Shiren no ShinkouKabu Shijo (Chuu) Todokooru Toushi Jouhou* (Being Tested by Emerging Stock Markets (China): Delays in Investor Information), 13 October 2006 edition of *Nihon Keizai Shimbun* (in Japanese).

[20] See Megumi Shuto, "*Kikan Toushika "Tanki Shiya" Haise*" (Institutional Investors should Reject Myopia), *Nihon Keizai Shimbun Keizai Kyoushitsu*, 12 October 2006.