Japanese Banks Enter Into Securities Intermediary Service

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Publication of Report by First Subcommittee of the Financial System Council

On 24 December 2003 the First Subcommittee of the Financial System Council published a report entitled "Towards a Market-Oriented Financial System" (Figure 1).

Figure 1 Main Proposals of "Towards a Market-Oriented Financial System"

(1) An Institutional Framework for Intermarket Competition ・Stock exchanges and proprietary trading systems need to be put on an equal competitive footing. —In addition to amending Article 37 of the Securities and Exchange Law and introducing a best execution rule, proprietary trading systems will be allowed to adopt the same auction pricing methods as stock exchanges. ・The Subcommittee commends the intention of the JASDAQ market to become a stock exchange as this should lead to greater intermarket competition. —The OTC market should be retained for the time being as a means of conducting spontaneous, directly negotiated transactions. ・The Green Sheet market should be made subject to the Securities and Exchange Law.
(2) Disclosure ・The prospectus system needs to be amended. —The information in investment trust prospectuses that is based on the information contained in securities registration statements should be divided into three sections: a prospectus section, an additional information section and a public information section. —The rules should be amended to permit the use for marketing purposes of any price-sensitive information other than that contained in the prospectus, provided this information does not misrepresent the facts or contradict the prospectus. ・In addition to trying to ease the conditions under which tender offers become mandatory, the rules should be eased to make it easier for companies to raise capital. ・Further consideration needs to be given to how disclosure documents in English and quarterly disclosure should be dealt with as well as to how the rules can be eased to allow the scope of the Securities and Exchange Law to be widened.
(3) Improving Market Supervision ・In order to ensure that action taken against infringements of rules is appropriate to the seriousness and nature of the infringement, a system of fines needs to be introduced and the existing system of injunctions and correction orders needs to be improved. ・In addition to making the Securities and Exchange Surveillance Commission responsible for virtually all regulatory inspections of securities companies, a clearer line needs to be drawn between its functions and those of self-regulating organizations such as the Japan Securities Dealers Association and the stock exchanges.

(4) Investor Protection ・Investment partnerships used to raise capital from the general investing public should be subject to the Securities and Exchange Law in the same way as investment trusts and special-purpose companies. ・As a medium-term objective the need for a broader framework (including the possibility of reworking the Securities and Exchange Law as an Investment Services Law) needs to be considered.
(5) Investor Education ・Regulatory bodies need to cooperate with the appropriate organizations in drawing up a standard model for both school and adult education.
(6) Improving Cooperation between Banks and Securities Companies ・Banks need to ensure that any advice or assistance they give to corporate borrowers intending to go public do not infringe Article 65 of the Securities and Exchange Law. ・Banks will be allowed to act as securities intermediaries (e.g., by soliciting orders for securities transactions from customers visiting their branches and channeling these orders to securities companies).

Source: NRI.

The report ties together the various strands of the debate on reforming Japan's financial system that followed the publication of the "Blueprint for Reforming Japan's Financial System and Financial Administration" in July 2002 and of the Financial Services Agency's "Program for Expediting Reform of Japan's Securities Markets" the following month. The report's recommendations are likely to be incorporated in the draft amendments to the Securities and Exchange Law due to be debated by the Diet in March 2004. Provided there are no hitches, they should be passed in June and come into effect several months later.

The report's wide-ranging recommendations are summarized in Figure 1. Of particular interest is (6) "Improving Cooperation between Banks and Securities Companies," which advocates that banks should be allowed to act as securities intermediaries. We will therefore focus on this aspect and consider the implications of the recommendations.[1]

Allowing banks to act as securities intermediaries

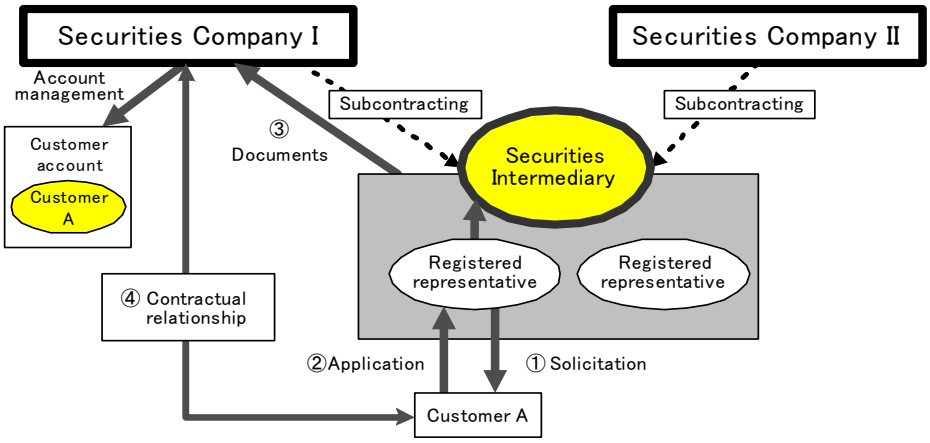
The recommendations of the Subcommittee's December 2002 report "Expediting Reform of Japan's Securities Markets" were incorporated in the amendments to the Securities and Exchange Law passed in June 2003 (Figure 2).[2] As its reason for recommending the introduction of a system of securities intermediaries the Subcommittee cited the need to offer investors greater physical access to a wide range

1 The author took part in detailed discussions of Sections (1) and (2) of the report ("An Institutional Framework for Intermarket Competition" and "Disclosure") by the Working Group on Market Reform and the Working Group on Disclosure. He has also expressed his personal opinions on intermarket competition in another report in this series: "Ongoing Reform of the Japanese Stock Market," Capital Research Journal, Winter 2003, p. 2 ff.

2 For further details, see Sadakazu Osaki, "The Latest Amendments to Japan's Securities and Exchange Law," Capital Research Journal, Summer 2003, p. 17 ff.

of high-quality financial services than that currently provided by the country's securities companies.[3]

Figure 2 Role of the Multi-Tied Securities Intermediary



Source: Financial Services Agency.

Before the Subcommittee made its recommendations, it apparently looked at financial services in the United States, including the "independent contractor" system, where professionals such as tax consultants, accountants and financial planners act as independent broker-dealers, and the "introducing broker" system, where broker-dealers outsource back office work such as clearing and order routing.

As a result, it was tacitly assumed by those involved in the debate on introducing a system of securities intermediaries in Japan that it would be mainly tax consultants, accountants, financial planners and insurance agents who would perform this role—mainly for the benefit of retail clients. It has also been reported in the media that non-financial companies such as the Internet retailer Rakuten Ichiba and the convenience store chain Lawson are planning to offer such a service.

However, the amendments to the Securities and Exchange Law contained a clause explicitly prohibiting banks and other financial institutions from acting as securities intermediaries (Article 66.2 of the Securities and Exchange Law)—perhaps in deference to Article 65 of the Law, which prohibited banks and other financial institutions from engaging in business normally conducted only by securities companies. However, it is not altogether clear from either the Subcommittee's report

[3] See First Subcommittee of the Financial System Council, "Expediting Reform of Japan's Securities Markets," p. 3.

proposing the introduction of the system or the debate in the Diet why such a clause was inserted in the amendments.

In contrast, the Subcommittee's December 2003 report recommended that any restriction on what type of businesses should be allowed to act as securities intermediaries should be abolished because this would (1) improve service by giving customers the option to use a one-stop shop, (2) encourage bank customers with no investment experience to try their hand, thereby enlarging the pool of investors, and (3) increase access to stockbrokerage services in places where securities companies were thin on the ground.[4] At the same time, the report acknowledged that to try to change the new system before it even came into effect (in April 2004) would be an admission of incompetence and would mean changing one of the assumptions (namely, that banks would not be allowed to offer this service) on which some businesses had made their plans.

Allowing banks to act as securities intermediaries would also benefit the banks by enabling them to (1) reduce their excessive dependence on net interest and increase their fee income; (2) offer their clients a wider range of investment options; and (3) gain a toehold in the stockbrokerage business without the expense and risk involved in setting up a stockbrokerage subsidiary.

As soon as the broad outline of the new system became clear, the author expressed his reservations: "…if the point of prohibiting banks and other financial institutions from engaging in stockbroking is, as is often claimed, to prevent conflicts of interest with customers or avoid putting the institutions at risk, it is difficult to see why it is necessary to prohibit an activity that only involves channeling orders to a securities company."[5] He therefore has no reason to object to the general aim of the amendment recommended in the December 2003 report.

However, if the intention of allowing banks to act as securities intermediaries is to help create a more market-oriented financial system, a number of issues—concerning both the general system and detailed business planning—need to be resolved first.

Securities intermediaries will simply be acting on behalf of securities companies—not as securities companies in their own right. This means that there is probably little risk of the kind of often discussed conflict of interests where a bank also acts as a securities company in its own right.

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4 See First Subcommittee of the Financial System Council, "Towards a Market-Oriented Financial System," pp. 30-31.

5 See Footnote 3, op. cit., p. 67, Footnote 6.

However, in cases where there is no guarantee that a securities company and a bank acting as its securities intermediary are maintaining an arm's length relationship (i.e., acting independently), the risk of a conflict of interests cannot be ruled out. For example, if a bank and a securities company are subsidiaries of the same financial holding company and therefore unable to make business decisions completely independently of one another, the bank may be in a position to exercise considerable influence over the securities company's decision. In such a situation it is impossible to rule out the possibility that the bank might call in its loans to a doubtful customer, ask the securities company to issue a bond on its customer's behalf and then sell the bond as the securities intermediary—a classic case of conflict of interests. There is also an increased risk of "tying" (i.e., that a bank might try to sell more of an affiliated securities company's products or boost the company's underwriting business by using its own credit).

The December 2003 report has the following to say about these risks:[6]

(1) Soliciting business by offering information about an issuer which a bank has obtained in its capacity as a bank or soliciting business on condition that a customer accepts the bank's credit is prohibited under existing law.

(2) Rather than automatically prohibiting a bank from acting as an securities intermediary for an affiliated securities company on the basis of external standards, the regulator will base his decision whether to allow a bank to act as a securities intermediary on whether the bank has proper (human and organizational) firewalls between its loan department and its securities intermediary department as well as proper internal controls over the communication of undisclosed information.[7]

(3) There must be proper arrangements in place between a bank and its stockbrokerage subsidiary to prevent the disclosure of information about how funds are used or the use of "tied deals" (i.e., lending money to a client on condition that he uses it to buy or sell securities).

(4) The markets must be supervised more rigorously to ensure that systems designed to prevent abuse work properly.

(5) Banks and securities companies must ensure that their counters are clearly demarcated—in the same way as this is done in jointly operated branches—in order to avoid any misunderstandings by customers.

The detailed process of putting this into practice is now under way. Every effort must be made to ensure that the banks, which are often in a stronger position than

6 See Footnote 6, op. cit., pp. 32-33.

7 Under the existing system securities intermediaries are required to be registered. The exception is banks and other financial institutions, which have to seek approval.

their customers as a result of the dominant role they have played in the Japanese financial system for many years, do not abuse their position in order to profit at their customers' expense. At the same time, however, care must be taken to ensure that they are not so heavily regulated that the quality of their service suffers.

One controversial issue, for example, is the extent to which banks acting as securities intermediaries should be allowed to use the information they hold on their depositors to solicit stockbrokerage business. Here, too, caution is the watchword.[8] However, if customers are to be given the most appropriate advice, the banks should perhaps be encouraged to use the information they hold on their depositors in customers' best interests. Moreover, information on depositors is not the same thing as information on borrowers—information that could indeed lead to abuses such as loans tied to investment advice—and is unlikely to give rise to serious abuses even if used to solicit stockbrokerage business.

The extent to which banks use the information they hold on their depositors will also be a decisive factor in whether their customers decide to use them as securities intermediaries on any significant scale. In the United States, it is clear from the fact that broker-dealers which systematically use tax consultants as independent contractors also offer investment advice to customers who use the consultants to file their tax returns that the securities companies' main aim in using tax consultants as securities intermediaries is to access their customer base.

Another issue is exactly what standards the regulator will use to decide whether to allow a bank to act as a securities intermediary. The December 2003 report recommends (see above) that, rather than automatically prohibiting a bank from acting as an agent for a securities company, the regulator should base his decision whether to allow a bank to act as a securities intermediary on whether the bank has proper (human and organizational) firewalls between its loan department and its securities intermediary department as well as proper internal controls over the communication of undisclosed information. In addition to these measures designed to prevent conflicts of interest, banks will presumably have to ensure that proper systems and staff are in place. Yet another issue is that, while a bank may stabilize its business by diversifying its sources of income, this also exposes it to new risks that may require it to increase its capital accordingly. This, in turn, raises the issue of whether banks that have used taxpayers' money to recapitalize should, for example, be allowed to engage in new areas of business.

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[8] See, for example, Yoshihiro Fujii, "Ginko no Shoken Chukaigyo Kaikin — Yokin Joho no Katsuyo Shincho ni" [Allowing Banks to Act as Securities company Agents: Information on Depositors Needs to Be Handled with Care], Nihon Keizai Shimbun, evening edition, 9 January 2004.

Issues facing potential securities intermediaries

The fact that the securities intermediary business is new to Japan means that there are not only regulatory but also practical business issues to consider when deciding whether to become a securities intermediary. Although the following comments refer to banks, many of them also apply to other institutions.

The first issue is what services a securities intermediary should decide to provide. In other words, agents will need to decide whether just to acquire customers on behalf of a securities company or whether also to provide appropriate financial planning and investment advice even after a customer has opened an account with the securities company.

Before the debate about whether banks should be allowed to become securities intermediaries even began, however, some commentators pointed out that setting up a consulting business is an expensive undertaking (because of training and other costs) and that the level of income that could be expected from offering just a basic introductory service would be minimal.[9] At least in the case of the banks, however, staff already have a basic knowledge of finance as well as some experience of securities as a result of selling investment trusts. The costs (e.g., of training) would therefore not be excessive.

Another point is that in the United States, which was taken as the model for Japan, securities intermediaries are only involved in retail broking. Now, while it is assumed that securities intermediaries in Japan will also focus on retail broking, there is nothing in Japanese law that requires them to restrict their activities to the retail market. In fact, they will be at liberty to provide not only secondary market broking but also primary market (public and private) offerings and distribution. It is perfectly possible to imagine situations where banks acting as securities intermediaries could advise their customers how to invest any surplus funds as well as introduce them to a securities company when they need to increase their capital or go public. They could even be involved in selling these shares themselves.

The second issue facing securities intermediaries is whether they want to act on behalf of one or more securities companies. While acting on behalf of several securities companies might appear better inasmuch as it offers customers more choices, what customers really want is a wide range of products and services rather than the ability to open accounts with umpteen different securities companies.

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9 See Mikio Fujii, "Shoken Chukaigyo wa Kin'yu Sabisu no Sugata o Kaeru" [Securities Intermediaries Will Change the Face of Financial Services], Kin'yu Zaisei Jijo [Financial and Fiscal Matters], 1 December 2003, p.26 ff.

Indeed, acting on behalf of several different securities companies could actually increase the risk of compliance problems, administrative complications and higher costs. For example, an agent would have to explain the commission structures of each securities company on whose behalf it was acting to a customer who placed an order. However, some investment trusts can only be sold by particular securities companies, and not all securities companies will be allocated shares in companies that are going public; so agents may want to keep as many options open as possible in order to offer their customers a wide product range.

The third issue is how securities companies can ensure that they have the necessary systems (e.g., for compliance) in place to be able to handle requests from securities intermediaries to open accounts and execute orders.[10] Ultimate responsibility for this lies with the securities companies themselves—not their securities intermediaries.

The Japan Securities Dealers Association has already informed its members that it is proposing to amend its articles of association so that members will be (1) held responsible for ensuring that their securities intermediaries have proper internal rules and their directors proper training and (2) fined if their securities intermediaries act improperly.[11] Although banks (as special members) may be treated differently from other agents, who will not be members, it is difficult to imagine an arrangement whereby securities companies (as principals and executors) are not held responsible.

Moreover, wherever responsibility may lie legally, an agent's reputation could be made or destroyed if a securities company on whose behalf it was acting did not have the necessary systems in place. Let us assume, for example, that Bank A advises Customer X to make an investment and that Customer X places an order with Securities Company Y, on whose behalf Bank A is acting, but suffers a loss as a result of an administrative error by Securities Company Y. Although, legally, this is entirely a matter between Customer X and Securities Company Y, Customer X is likely to hold Bank A, which recommended Securities Company Y, at least partly responsible.

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10 Ibid.

11 See Japan Securities Dealers Association, "Shoken Chukaigyo Seido no Sosetsu ni Tomonau Honkyokai Teikan no Minaoshi ni Tsuite" [Amendments to the Association's Articles of Association in Connection with the Introduction of a System of Securities Intermediaries], 14 January 2004.

Outlook

As was mentioned earlier, the December 2003 report recommended that banks should be allowed to act as securities intermediaries because this would (1) improve service by giving customers the option to use a one-stop shop, (2) enlarge the pool of investors, and (3) increase access to stockbroking services in places where securities companies were thin on the ground. Let us now consider what will be required to achieve these aims.

The most immediate effect of allowing banks to act as securities intermediaries is likely to be an increase in the pool of investors. By selling investment trusts on behalf of investment trust companies, the banks have already demonstrated that they can interest large numbers of novices in securities investment. The undeniable fact that for many people banks are a more familiar presence than securities companies means that some will gain their first real experience of securities investment via a bank.

Whether or not the banks can offer their customers a better service by functioning as a one-stop shop will depend on whether they can offer their customers products and services that will really make them better off rather than simply serving their own interests.

The development of the Internet means that simply increasing the number of one's retail outlets is less important than it used to be. What investors want is not simply to be able to purchase a wide range of financial products (be they bank deposits, insurance policies or securities) from one outlet but to be offered such products at the right time and in the right combination for their own particular life plan and investment aims.

It should also be borne in mind that US and European experience indicates that attempts by financial institutions to offer their customers one-stop shopping are not always successful. For example, one of the reasons Prudential Financial sold its controlling stake in its stockbrokerage subsidiary, Prudential Securities, complete with an army of sales representatives to Wachovia Corporation was that it was less successful in cross-selling insurance policies and securities than it had hoped. For its part, Wachovia, is cautious about merging its newly acquired stockbrokerage outlets with its existing banking outlets because of the wide culture gap between the two.[12]

[12] Based on interviews with both organizations.

Caution is also called for when it comes to the third reason the December 2003 report recommended that banks should be allowed to act as securities intermediaries: increasing access to stockbrokerage services in places where securities companies are thin on the ground. The report tacitly assumes that, when banks act as securities intermediaries, they will offer these services through their own branch outlets. However, this is only one of a number of business models for securities intermediaries, and the possibility that banks might opt for a different model cannot be ruled out.

Also, even if banks do acquire customers for securities companies in places where the latter are thin on the ground, the actual transactions could be carried out on the Internet or by telephone. This is not to deny that banks may succeed in attracting investors who had hitherto been relatively unaware that stockbrokerage services were available on the Internet or by telephone. However, this is not the same thing as the increase in securities company branch outlets that the report appears to assume.

Conclusion

Partly because it proposed major amendments to legislation that had not yet come into effect, the debate on whether banks should be allowed to act as securities intermediaries elicited both strong objections and cautious comments from securities companies as well as attracting attention as a tug-of-war between rival interest groups. Some commentators even said that securities companies were afraid that the banks were going to invade their territory. However, the issue of how to regulate rival industries and how far to allow businesses to operate on both sides of traditional demarcation lines is one that should be decided on the basis of the expected costs and benefits to users (or the general public) of changing the system—not the costs and benefits to the businesses themselves.

As has already been mentioned, allowing banks to act as securities intermediaries risks creating a conflict of interest between them and their customers under certain circumstances, although not on the same scale as allowing banks to operate as full-service securities companies would. At the same time, however, there is no denying that the national need to create a more market-oriented financial system requires policies that will encourage more members of the public to invest in securities. Let us hope that the latest amendments to the rules governing securities intermediaries will help to revitalize Japan's securities markets by leading to effective measures to prevent abuses as well as to a business model that offers customers a high-quality service.