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# Spawning the SEC

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# Spawning the SEC

HENRY LAURENCE\*

## INTRODUCTION

Has the globalization of the world economy caused convergence in the economic or regulatory policies of different countries? If so, are the standards converging at higher or lower regulatory standards? The evidence presented in this Article suggests that in at least one area—the regulation of financial markets—there has been a significant degree of institutional convergence across three major countries and that convergence has been toward an American model of higher regulatory standards of consumer protection.

One of the immediate results of the Asian currency crisis was the establishment of the Financial Supervisory Agency (FSA) in South Korea in April 1998. Yet this reform is only the latest in a broad trend in which different countries are adopting American-style institutions of investor protection. Within the past decade, the United Kingdom, Germany, and Japan have all created new bureaucratic agencies responsible for supervising financial markets and ensuring high standards of investor protection on stock exchanges. The British founded the Securities and Investments Board (SIB) in 1986. The Japanese founded the *Shoken Torihiki Kanshi Ii Inkai* (Securities and Exchange Surveillance Commission or SESC) in 1992. The Germans founded the *Bundesaufsichtamt für den Wertpapierhandel* (Federal Supervisory Office for Securities Dealing) in 1994. All four new agencies resemble each other in several important respects, and all were modeled, at least in part, on the United States' Securities and Exchange Commission (SEC) established in 1934. The creation of these agencies, therefore, represents a significant convergence of the ways in which these countries regulate their financial markets.

This institutional convergence is theoretically interesting for three reasons. First, convergence undermines the predictions of a number of scholars of comparative politics who argue that individual countries will retain

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unique regulatory and economic structures indefinitely. Second, reform in each country was the result of a complex interaction of external economic factors and national political battles, making it impossible to give simple causal priority to either domestic or international variables. Finally, convergence has been toward a higher standard of regulation, defying the expectation that globalization will result in a competition in deregulator laxity.

In this Article, I examine the origins of reform in these four countries; and I argue that the United Kingdom, Japan, and Germany all consciously chose to remodel their institutions of financial oversight along broadly American lines.<sup>1</sup> However, all countries, beginning with the United States, reformed their regulatory institutions in response to predominantly *domestic* political pressures. All four governments introduced new “watchdog” agencies in the face of domestic criticism of existing regulatory arrangements. This criticism was in each case prompted by financial scandals that revealed corrupt practices in stock and bond markets, along with the exploitation of investors by banks, brokers, and other financial intermediaries. While the circumstances of scandal were different in each country, they shared certain common features stemming from the similar nature of financial corruption across countries—a corruption which stems from the huge information asymmetries between providers and users of financial services.

However, the internationalization of financial markets—defined as an increase in the value of cross-border economic transactions relative to domestic transactions<sup>2</sup>—played a vital role in determining the form of the regulatory outcomes in every case except the United States. First, financial integration changed the preferences of many key actors with regard to the appropriate type and level of regulation. Local bankers, brokers, and regulators who had previously been opposed to regulatory reform came to realize that foreign investors were deterred from doing business in markets perceived as unfair. By contrast, regulatory structures that provided strong enforcement of investor protection laws were seen as a benefit in attracting foreign business. In other words, internationalization changed the economic incentives of both private firms and national governments in favor of *higher* regulatory standards. Second, internationalization facilitated the use of American regulatory institutions as a model for other countries. Financial

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1. The case of the Korean FSA, while fascinating, is too recent for adequate discussion in this Article.

2. I am indebted to Ken Oye for this definition.

internationalization encouraged such emulation in two ways. First, by increasing the general level of international cooperation and discussion between national regulatory authorities; and, second, by increasing the familiarity of national financial firms and investors with foreign regulatory structures. In this regard, the perceived success of the American regulatory model in achieving the goal of investor protection was a key component of its adoption in other countries.

In Part I, I briefly review the literature on internationalization and convergence, highlighting the debate between those who expect convergence and those who do not. In Part II, I consider predictions about whether, assuming that there is regulatory convergence, it will be toward higher or lower standards. I then discuss the cases of institutional reform chronologically in Part III. The four countries under discussion—the United States, the United Kingdom, Germany, and Japan—present a “hard case” for the convergence thesis. They are among the biggest economies in the world and should, therefore, be among the most immune to the influence of international pressures for change. More importantly, they have until recently been very distinct from one another in terms of political institutions, regulatory traditions, and financial systems. Indeed, many scholars use these four countries not merely to illustrate but to *define* different models of financial regulation.<sup>3</sup> To see institutional convergence in these countries would, therefore, be a surprising and important finding.

### I. CONVERGENCE OR DIVERSITY?

One of the most controversial debates within the subfield of international political economy concerns the degree to which internationalization has caused cross-national policy convergence as formerly sovereign States react to the pressure of international competition with common policy responses. I define convergence as the process by which the rules, regulations, or political institutions governing economic activity in different countries become more similar. Under this definition, regulatory convergence implies that regulations in two or more countries become more similar over time, but it does not necessarily imply that regulatory structures are, or will become, identical.

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3. See, e.g., JOHN ZYSMAN, *GOVERNMENTS, MARKETS, AND GROWTH* (1983) (focusing on the United States, the United Kingdom, West Germany, and Japan).

There are good theoretical grounds for expecting that at least some degree of cross-national policy convergence will follow an increase in global economic integration. Internationalization allows holders of mobile assets to pick and choose the country in which they do business, and their decisions will be based at least in part on the relative attractiveness of each country's policies. International portfolio investors decide where to put their money by comparing different fiscal and monetary policies. Multinational corporations planning foreign direct investment will take into account different legal and regulatory structures. Accordingly, countries wishing to attract international businesses will need to tailor their monetary, fiscal, and regulatory policies to the standards of the international marketplace.<sup>4</sup> The result is a competitive dynamic in which policy choices in different countries converge on those most preferable to internationally mobile businesses.<sup>5</sup>

Many scholars argue that in recent years regulatory reform in advanced industrial democracies has indeed demonstrated convergence. John Goodman and Louis Pauly examine the liberalization of capital markets in advanced industrial democracies and conclude that "the fundamental convergence in the direction of capital [market liberalization] noted in all of our case studies suggests that systemic forces are now dominant in the financial area."<sup>6</sup> Michael Webb examines changes in the patterns of international coordination of macroeconomic adjustment policies under the impact of international capital market integration. He, too, identifies a common pattern of policy shifts from the mid-1960s to the early 1980s, caused by the structural pressure

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4. This dynamic cuts in two ways. Governments are faced with the twin pressures of attracting foreign firms into the country and preventing the exit of domestic firms to other, more economically attractive, countries.

5. This process is well described by Kurzer, who writes that "[h]igh capital mobility and deepening financial integration prompt governments to remove or alter institutions and practices objectionable to business and finance." PAULETTE KURZER, *BUSINESS AND BANKING: POLITICAL CHANGE AND ECONOMIC INTEGRATION IN WESTERN EUROPE* 245 (1993).

6. John B. Goodman & Louis W. Pauly, *The Obsolescence of Capital Controls: Economic Management in an Age of Global Markets*, 46 *WORLD POL.* 50, 80-81 (1993). Notice that these authors infer the power of mobile capital from the evidence of cross-national policy convergence. See also Louis W. Pauly, *National Financial Structures, Capital Mobility and International Economic Rules: The Normative Consequences of East Asian, European, and American Distinctiveness*, 27 *POL'Y SCI.* 343 (1994).

of globalization.<sup>7</sup> David Andrews also argues that the recent increase in capital mobility exercises a common, systemic influence on the policy choices of individual States.<sup>8</sup>

On the other hand, relatively equal numbers of scholars reject the “convergence thesis” and argue that States still pursue diverse policy choices. Jeff Garret examines the hypothesis that international financial integration will lead to an erosion of the Keynesian welfare policies of West European States and concludes that, although increased capital integration over the past twenty years has exerted “powerful pressures for convergence in economic policies,”<sup>9</sup> such convergence has not happened, and that “the evidence on fiscal policy conflicts sharply with the convergence thesis.”<sup>10</sup> Michael Loriaux argues that regulatory reform in the 1980s in France was the strategic choice of a rational State actor. “The French state sought through liberalization to regain control over its monetary authority and not . . . to surrender the future evolution of the French political economy to the laws of the marketplace.”<sup>11</sup> Sofia Perez explicitly rejects the convergence thesis in her study of credit regulation in Europe during the 1970s and 1980s.<sup>12</sup> The fact that some countries adopted selective credit regulation while others did not

7. Michael C. Webb, *International Economic Structures, Government Interest, and International Coordination of Macroeconomic Adjustment Policies*, 45 INT’L ORG. 309, 310-13 (1991); see also MICHAEL C. WEBB, *THE POLITICAL ECONOMY OF POLICY COORDINATION: INTERNATIONAL ADJUSTMENT SINCE 1945* (1995).

8. David M. Andrews, *Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations*, 38 INT’L STUD. Q. 193 (1994); see also DAVID M. MEERSCHWAM, *BREAKING FINANCIAL BOUNDARIES: GLOBAL CAPITAL, NATIONAL DEREGULATION, AND FINANCIAL SERVICES FIRMS* (1991); SAM L. HAYES III & PHILLIP M. HUBBARD, *INVESTMENT BANKING: A TALE OF THREE CITIES* (1990); RALPH BRYANT, *INTERNATIONAL FINANCIAL INTERMEDIATION* (1987); George Stigler, *The Regularities of Regulation*, in *FINANCIAL DEREGULATION I* (Richard Dale ed., 1986). In the popular press, the “convergence thesis” is well represented. See GREGORY J. MILLMAN, *THE VANDALS’ CROWN: HOW REBEL CURRENCY TRADERS OVERTHREW THE WORLD’S CENTRAL BANKS* (1995); RICHARD O’BRIEN, *GLOBAL FINANCIAL INTEGRATION: THE END OF GEOGRAPHY* (1992); KENICHI OHMAE, *THE BORDERLESS WORLD: POWER AND STRATEGY IN THE INTERLINKED ECONOMY* (1990).

9. Geoffrey Garrett, *Capital Mobility, Trade, and the Domestic Politics of Economic Policy*, 49 INT’L ORG. 657, 657 (1995).

10. *Id.* at 659. See also Geoffrey Garrett & Peter Lange, *Internationalization, Institutions, and Political Change*, 49 INT’L ORG. 627, 627-29 (1995) (arguing against the functionalist reasoning that assumes changes in actor preferences caused by international economic changes hardly ever map cleanly onto domestic political outcomes).

11. MICHAEL LORIAUX, *FRANCE AFTER HEGEMONY: INTERNATIONAL CHANGE AND FINANCIAL REFORM* 14 (1991).

12. Sofia Perez, *Macroeconomic Choices and Institutional Change: The Politics of Financial Interventionism and its Abandonment in Post-War Europe* (paper presented to the annual 1995 meeting of the American Political Science Association (APSA) in Chicago).

prompts her to argue that “domestic and politically motivated macroeconomic policy choices by government officials play a much greater role in driving change and determining regulatory outcomes than is generally recognized.”<sup>13</sup>

Three recent studies of financial reform in Japan, two of which look also at the United Kingdom, reject the view that international factors played a determining role in prompting regulatory change and argue against the convergence thesis. Ulricke Schaede offers one of the clearest defenses of the view that no policy convergence has occurred and that Japan has retained distinctive institutions. She writes that within the Japanese regulatory framework “there is no indication whatsoever of convergence” with the United States’ system “or any other system of capitalism.”<sup>14</sup> Changes in regulations were, she writes, “a pragmatic adaptation to the ways in which the world is turning on Japan” revealing no underlying change in the way the Japanese public or bureaucracy conceive of regulation.<sup>15</sup> Steven Vogel argues that there are still nationally distinct patterns of regulatory change and distinguishes between the centralized, methodical, controlled, and “bureaucrat-led” regulation in Japan and the more fragmentary, speedy, and marketized reform process in the UK.<sup>16</sup> In the case of Japan, he argues that bureaucrats within the Ministry of Finance (MOF) “have still managed to run their financial revolution their way” and that “the evidence from the financial system reform case strongly supports my contention that MOF officials have followed their own priorities—and not those of financial institutions or party politicians.”<sup>17</sup> Finally, Andrew Sobel writes of changes in global financial markets that “the international outcome [of financial integration] is solidly rooted in domestic

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13. *Id.* at 2.

14. Ulricke Schaede, *Change and Continuity in Japanese Regulation* (Haas School of Business Working Paper No. 66, 1994), available at <<http://bric.berkeley.edu/~briewww/pubs/wp/wp66>>.

15. *Id.*

16. Steven K. Vogel, *The Bureaucratic Approach to the Financial Revolution: Japan's Ministry of Finance and Financial System Reform*, 7 *GOVERNANCE* 219, 222-23 (1994) [hereinafter Vogel, *The Bureaucratic Approach to the Financial Revolution*]; see also STEVEN K. VOGEL, *FREER MARKETS, MORE RULES: REGULATORY REFORM IN ADVANCED INDUSTRIAL DEMOCRACIES* (1996).

17. Vogel, *The Bureaucratic Approach to the Financial Revolution*, *supra* note 16, at 219, 237 (alternation in original).

policy dilemmas and distributional debates,"<sup>18</sup> and that "[financial] markets remained distinctively national."<sup>19</sup>

The disagreements between those who see policy convergence and those who do not can only partly be explained as a matter of emphasis or as the consequence of different definitions of convergence. The disagreements also stem from a more fundamental dispute over the relative importance of international versus domestic level factors in explaining national policy outcomes.<sup>20</sup> Both sides appear to see policy convergence as *prima facie* evidence for the greater importance of international (or systemic) level forces in driving domestic policy reform. Accordingly, the interpretation of the empirical evidence for whether convergence has occurred has become highly contentious. Since the issue of convergence is essentially an empirical one, one of the main purposes of this Article is to bring new evidence to bear on the debate. In doing so, however, I do not subscribe to the position that arguing that there has been policy convergence necessarily means arguing that international forces now play a unique causal role in shaping national policy outcomes.

## II. DEREGULATION OR REREGULATION?

Assuming that we do expect regulatory convergence, upon what standard will regulations converge? There are at least two competing hypotheses: the "competition in laxity" and the "race to the top." The "competition in laxity" hypothesis posits that regulations are costly to business.<sup>21</sup> Therefore, businesses will whenever possible migrate to the country with the lowest level of regulations. As soon as financial investors are able to transact in foreign markets, they will flock to the country with the lowest level of regulations. Ralph Bryant writes that because:

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18. ANDREW C. SOBEL, *DOMESTIC CHOICES, INTERNATIONAL MARKETS* 19 (1994).

19. *Id.* at 143.

20. This is, of course, the essence of the "second image reversed" debate. For the classic works on this debate, see PETER J. KATZENSTEIN, *SMALL STATES IN WORLD MARKETS: INDUSTRIAL POLICY IN EUROPE* (1985); Peter Gourevitch, *The Second Image Reversed: The International Sources of Domestic Politics*, 32 *INT'L ORG.* 881 (1978). See also *INTERNATIONALIZATION AND DOMESTIC POLITICS* (Robert O. Keohane & Helen V. Milner eds., 1996).

21. *FINANCE AND WORLD POLITICS: MARKETS, REGIMES AND STATES IN THE POST-HEGEMONIC ERA* 15 (Philip G. Cerny ed., 1993) [hereinafter *FINANCE AND WORLD POLITICS*].



Financial intermediation is more “footloose” than most other economic activities . . . the scope exists for an individual locality or nation to try to lure financial activity within its borders by imposing less stringent regulation, taxation, and supervision than that prevailing elsewhere . . . [that] can be described—provocatively—as a “competition in laxity.”<sup>22</sup>

Charles Kindleberger’s discussion of the same phenomenon includes the prediction that “[d]eregulation may induce the discarding of safeguards that were considered important in ensuring the protection of the ordinary investor: . . . prohibitions against insider trading and the like.”<sup>23</sup> Adherents to the “competition in laxity” view, then, expect that the increased internationalization of finance will be accompanied by a “race to the bottom” where States compete for financial business by lowering regulatory standards.<sup>24</sup> Yet such a race to the bottom has not always happened. On the contrary, although deregulation follows internationalization on some issues, a shift to *higher* standards of regulation has occurred in others. This turns the “competition in laxity” theory on its head.

The “race to the top” hypothesis predicts that in an open world economy States will engage in competitive *reregulation*. The underlying logic is much the same as that for the competition in laxity. The only difference is in the expectations of business preferences, which in this model are assumed to be for higher rather than lower regulatory standards. Barry Weingast, for example, accounts for the rapid growth of the United States economy in the 1880s by noting that there were few barriers to capital movement across state boundaries, and that the states competed with each other to attract capital by

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22. BRYANT, *supra* note 8, at 139. See also FINANCE AND WORLD POLITICS, *supra* note 21.

23. CHARLES P. KINDLEBERGER, INTERNATIONAL CAPITAL MOVEMENTS 72 (1987).

24. A very striking example of the desire of certain types of business to migrate to lax regulatory climates is the recently-revealed copper trading losses incurred by Sumitomo Corporation on the London Metal Exchange (LME). The LME had much more lax rules than its rival, New York’s Commodities Exchange (Comex), over issues of disclosure of trading positions, off-exchange trading, credit arrangements, price reporting, punishment for infringement of regulations, and the ability of regulators to trade on the exchange. Perhaps as a result of this laxity, trading volume of copper on the LME is nearly *twenty times* the volume on Comex. It will be interesting to see whether the revelation of Sumitomo’s market manipulation will result in any strengthening of regulation on the LME. Stephanie Strom, *A Market Ripe for Manipulation*, N. Y. TIMES, July 12, 1996, at D1, D3.

promising to create secure property rights.<sup>25</sup> More recently, David Vogel argued that increased levels of international trade have been accompanied by an *upward* shift in the regulatory standards for consumer and environmental protection. In his words, the “California effect” has outweighed the “Delaware effect.”<sup>26</sup> Vogel notes that this shift has three components:

First, to the extent that stricter regulations represent a source of competitive advantage for domestic firms, the latter may be more likely to support them. Second, rich nations which have enacted greener product standards for foreign producers to adjust to them in order to continue to enjoy market access. Third, agreements to reduce trade barriers can provide richer and more powerful greener nations with the opportunity to pressure other nations into adopting stricter product and production standards.<sup>27</sup>

In summary, then, the literature on comparative politics and international political economy leaves two important questions open. First, are regulatory, and other, policies converging across different countries, or do individual countries retain distinctive institutional structures and policies? Second, to the extent that policy convergence does occur, toward what standard are countries moving—the higher or the lower?

### III. INVESTOR PROTECTION REGULATION IN SECURITIES MARKETS

The following cases examine how different countries developed institutional mechanisms to regulate and monitor the conduct of business on securities markets. I regard the issue of investor protection as essentially a

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25. Barry R. Weingast, *Constitutions as Governance Structures: The Political Foundations of Secure Markets*, 149 J. INST'L & THEORETICAL ECON. 287, 295 (1993).

26. DAVID VOGEL, *TRADING UP: CONSUMER AND ENVIRONMENTAL REGULATION IN A GLOBAL ECONOMY* 5-6 (1995). Delaware has the least demanding state laws covering incorporation, so companies who want to avoid excessive state regulation would set up their headquarters there. By contrast, California sets high regulatory standards for companies incorporated there.

27. *Id.* at 259-60.

case of consumer protection.<sup>28</sup> Investors in stocks, bonds, and other types of securities face two kinds of risk. The first is market risk: the possibility that the stock they buy will fall in price. This is not something that regulation can (or should) prevent, and most governments follow the doctrine of caveat emptor—"let the buyer beware." However, investors also face "transaction risk," which is the possibility that the banker or broker through whom they deal may be dishonest and rip them off, for example, by selling them stock at an artificially inflated price or by "insider trading" of stock. Financial markets are characterized by high information asymmetries and inherent principal-agent problems, so better-informed brokers have plenty of opportunities to exploit investors, especially individual "retail" investors. This is the kind of "market failure" problem that regulations can and should address. However, whether governments will provide investor protection regulations, and of what sort, are open questions. All regulations have distributional consequences and are therefore subject to political conflict.<sup>29</sup>

In Parts IV through VII, I show that until the 1980s all four countries had employed different regulatory strategies to protect investors. However, the United Kingdom, Germany, and Japan have recently been moving toward the American approach.

#### IV. THE UNITED STATES: THE SECURITIES AND EXCHANGE COMMISSION, 1934

The SEC was established in the aftermath of the 1929 Wall Street crash. Prior to the 1930s, no national regulation of the securities industry existed, although individual states had enacted various antifraud laws. The coordinated lobbying efforts of the securities industry, spearheaded by the Investment Bankers Association, had ensured that the few state laws in place were full of exemptions.<sup>30</sup> The Hoover administration, indeed, had actively resisted proposals to enact federal regulatory standards for the security

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28. See C.A.E. GOODHART, *MONEY, INFORMATION, AND UNCERTAINTY* (2nd ed. 1989) (discussing market failure and regulation in financial markets).

29. For the classic texts on the politics of regulation, see *THE POLITICS OF REGULATION* (James Q. Wilson ed., 1980); Sam Peltzman, *The Growth of Government* 23 *J.L. & ECON.* 209 (1980); George Stigler, *The Theory of Economic Regulation*, 2 *BELL J. OF ECON. & MGMT. SCI.* 3 (1971).

30. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 45 (1982).

industry.<sup>31</sup> Investors did not seem to care much, however, and the stock markets boomed during the 1920s. The 1929 Wall Street crash changed the situation dramatically. Between September 1929 and July 1932, the value of stocks listed on the New York Stock Exchange (NYSE) fell 83%, from \$90 billion to \$16 billion. The crash preceded a massive national depression, and many blamed the problems of the economy on the activities of the financial markets.<sup>32</sup> Ferdinand Pecora, counsel for the Senate Committee on Banking and Currency, investigated practices on the stock exchanges and in the banking and securities markets. These investigations, known as the Pecora Hearings, lasted from January 1933 to July 1934.<sup>33</sup>

The hearings revealed extensive abuses in the stock markets. Many of the abuses centered around price manipulation and the spreading of financial misinformation. Sometimes speculators would secretly initiate heavy trading in a particular stock to manipulate its price upward (a “ramp”) or downward (a “bear raid”). Manipulators often used “wash sales,” no-risk sale-and-repurchase agreements, to generate artificial trading volume and buying interest in stocks. Many brokers clubbed together in speculative pools where they could trade on inside information under assumed names. Journalists were bribed to write favorable news articles to boost particular stocks.<sup>34</sup> Bankers also admitted to treating clients unequally, keeping highly secret “preferred lists” of influential customers. In one such case, J.P. Morgan offered to sell stock in the about-to-be-listed Alleghany Corporation to selected clients at a price of \$20 per share. The stock was already trading publicly on a “when-issued” basis at \$37 per share, so the offer by Morgan was essentially a gift. The “preferred list” of clients in this case included ex-President Coolidge, General Pershing, and dozens of senior politicians and cabinet members including at least one former Secretary of the Treasury, Senator William Gibbs McAdoo.<sup>35</sup>

The revelation of these practices gave rise to a huge public outcry and to demands for wholesale reform of the regulatory structure of the financial markets. The outcome was a series of new laws including the Securities Act

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31. SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 8 (1981).

32. ROBERT SOBEL, *PANIC ON WALL STREET* 351-52 (1968).

33. See FERDINAND PECORA, *WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS* (1939) (giving a first-hand account of the hearings).

34. See SELIGMAN, *supra* note 30, at 17.

35. PECORA, *supra* note 33, at 27-31. The list also included former chairmen of both the Democratic and the Republican National Committees, the ex-President of the American Bar Association, and most of the highly prominent business leaders in the country.

of 1933 (1933 Securities Act), the Securities Exchange Act of 1934 (1934 Exchange Act), and the Banking Act of 1935 (the Glass-Steagall Act). These laws are the basis for the current regulatory structure in the United States. The 1933 Securities Act tackled abuses in the new-issue markets by requiring issuers of securities to disclose relevant financial information so that would-be investors could make more informed judgments about the stock on offer. The purpose of the Act was, in the words of sponsor Senator Rayburn, to ensure that the investor had “all information that is pertinent that would put him on notice and on guard, and then let him beware.”<sup>36</sup> On the other hand, the bill would not, and was not intended to, “prevent anybody from putting his money into rat holes or into highly speculative ventures if he sees fit to do so.”<sup>37</sup> The Federal Trade Commission (FTC) was given responsibility to enforce the 1933 Securities Act.

The 1934 Exchange Act was more extensive and tackled fraudulent trading practices. The Act created the SEC to oversee trading on stock exchanges and to administer the provisions of the new securities laws. The 1934 Exchange Act required that all brokers, dealers, and securities registered on an exchange be licensed, and gave the licensing authority to the SEC. It also gave the SEC considerable power over market participants, short-selling, the use of customers’ accounts held in custody, and over all forms of market manipulation.

The SEC was created as a compromise between Congress and the financial community. The Roosevelt administration originally wanted to give extensive authority over securities markets to the FTC. The 1933 Securities Act was the first step in that direction. The Wall Street community was initially opposed to the idea of any supervisory regulation whatsoever. Richard Whitney, President of the NYSE, claimed that it was a “perfect institution.”<sup>38</sup> However, opinion both in Washington and in the country at large was running strongly against Wall Street. Pecora believed that the NYSE was “in reality neither more nor less than a glorified gambling casino

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36. THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY: A LEGISLATIVE HISTORY OF U.S. REGULATORY AGENCIES 2550 (Bernard Schwartz ed., 1973) [hereinafter THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY].

37. *Id.* at 2606.

38. PECORA, *supra* note 33, at 259.

where the odds [are] heavily weighted against the eager outsiders.”<sup>39</sup> Senator Rayburn declared of the investment banking community that “these hired officials of our great corporations . . . these few men, proud, arrogant, and blind, drove the country to financial ruin.”<sup>40</sup> Seeing the writing on the wall, the bankers mobilized to lobby for a new regulatory commission. They were afraid of the power of the FTC and apparently believed that a separate commission would be easier to influence. They lobbied hard, and with some success, to appoint pro-business officials to the SEC. The first Chairman, Joseph Kennedy, was a morally reprehensible Wall Street insider who had himself been deeply implicated in some of the worst abuses on the NYSE.<sup>41</sup>

Despite this inauspicious start, however, the SEC quickly proved remarkably effective in combating the sorts of abuse and market manipulation that were characteristics of the pre-1929 period. Kennedy left after a year, and in his wake, came a series of ideologically committed New Dealers, including James M. Landis, William O. Douglas, and Jerome Frank. They stressed nonpartisanship, agency independence, and high moral standards as the keystones of the SEC. Douglas boasted that in his day “no taint of unethical conduct ever touched it, nor did partisan politics motivate it. Above all else, the commission’s performance was highly professional.”<sup>42</sup>

The SEC was relatively inactive during the 1940s and 1950s. It was deemed not to be important to the war effort, and the Eisenhower administration cut its budget drastically. The SEC returned to public prominence under Chairman William Carey during the “Great Society” expansion in the 1960s. It took important steps in outlawing the practice of insider trading in a series of landmark cases including *Cady Roberts & Co.*,<sup>43</sup> and *SEC v. Texas Gulf Sulphur Co.*<sup>44</sup> The Williams Act of 1968 gave the SEC the power to develop and administer rules on corporate takeovers. The agency suffered a minor scandal in 1973 when Chairman Brad Cook was forced to resign in the wake of allegations that he had given favorable treatment to a key member of President Nixon’s staff, but it soon won back its lost prestige. Stanley Sporkin, Director of the Division of Enforcement, led what was

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39. *Id.* at 263.

40. THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY, *supra* note 36, at 2619.

41. Senator Edward Kennedy is reported to have said that the appointment of his father as Chairman of the SEC was the worst appointment they ever made. See ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 47 (1982).

42. *Id.* at 49 (quoting WILLIAM O. DOUGLAS, GO EAST, YOUNG MAN 269 (1974)).

43. *Cady Roberts & Co.*, 40 S.E.C. 907 (1961).

44. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971).

practically a crusade against market malpractice, and the agency won a reputation as perhaps the strongest and most respected of all bureaucratic agencies. Senator Proxmire said that “[i]t’s the strongest single unit that I know in the federal government . . . the SEC has the reputation of being the best agency—the most honest, most effective, with the most integrity.”<sup>45</sup> Some observers claim that it became too successful, because the relentless pursuit of its primary mission of investor protection came at the expense of other considerations, such as the promotion of national securities markets or efficient capital formation.<sup>46</sup> Whatever the merits of this criticism, no one disputes that “[b]y the end of the 1970s the SEC was the institution in Washington that Wall Street and Corporate America feared most.”<sup>47</sup>

#### V. THE UNITED KINGDOM: THE SECURITIES AND INVESTMENTS BOARD, 1986

The British historically relied on a mixture of self-regulation and informal guidance to police their stock markets. Until the 1980s, the United Kingdom’s domestic securities markets were small and insular, centered around the London Stock Exchange and the surrounding “Square Mile” of the City of London. Regulatory responsibilities were divided among the Bank of England, the Treasury, the Department of Trade and Industry, and the London Stock Exchange itself. Close social ties between the regulators and the regulated allowed for a high degree of informality in oversight, and also facilitated what was, for centuries, a relatively effective form of self-regulation. The stock exchange motto, “My Word is My Bond,” worked reasonably well as a form of investor protection as long as the membership of the exchange was limited to a small, socially cohesive group.<sup>48</sup>

However, during the 1970s, an increasing amount of investment business was being conducted outside the London Stock Exchange. In the late 1970s and early 1980s, a series of well-publicized scandals involving investment

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45. KARMEL, *supra* note 41, at 70 (quoting Connie Bruck, *Waning Days for the Zealot at the SEC*, AM. LAW., Nov. 1980, at 16).

46. *See id.* at 101-38.

47. DAVID A. VISE & STEVE COLL, *EAGLE ON THE STREET* 9 (1991).

48. For an analysis of the social ties within the “City,” see T. Lupton & C. Wilson, *The Social Background and Connections of Top Decision Makers*, 27 MANCHESTER SCH. ECON. & SOC. STUD. 30 (1959); Michael Lisle-Williams, *Beyond the Market: The Survival of Family Capitalism in the English Merchant Banks*, 35 BRIT. J. SOC. 241, 241-71 (1984).

firms outside the London Stock Exchange proved politically embarrassing.<sup>49</sup> The Slater-Walker scandal, in 1975-77, was probably the most well-known of these scandals. In 1981, Norton-Warburg, a supposedly "mainstream" investment management group, went bankrupt, losing £4.5 million of client funds. Its director was jailed on fraud charges. These and other cases rarely involved large sums of money in absolute terms, but they often involved a few individuals losing their entire life savings. As such, they made good headlines and great copy.

The British Conservative Party was "not insensitive" to charges of favoritism toward the City. It was particularly aware that its plans for massive privatization and the creation of a "shareholders' democracy" would be threatened if private investors lost confidence in the propriety of the markets.<sup>50</sup> So, in July of 1981, the Minister of Trade commissioned Professor Jim Gower to undertake a report on investor protection. Gower's report was the basis for a White Paper in January 1985 and was passed into law as the Financial Services Act (FSA) in November 1986.

Gower's report had stressed that the level of regulation and supervision should not "seek to achieve the impossible task of protecting fools from their own folly," but that it should be "no greater than is necessary to protect reasonable people from being made fools of."<sup>51</sup> Unfortunately, the definition of what should be "necessary" to protect people and what constituted "reasonable" were not made clear. Moreover, Gower was not required to, nor did he, consider the costs of regulation. Consequently, the FSA came down on the "safe" side of heavy regulation. Chancellor of the Exchequer Nigel Lawson wrote that, "what eventually emerged was something far more cumbersome and bureaucratic than I, or, I believe any of us in Government had ever envisaged."<sup>52</sup> The original bill consisted of 212 sections, 300 pages,

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49. See JULIAN FRANKS & COLIN MAYER, *RISK, REGULATION AND INVESTOR PROTECTION: THE CASE OF INVESTMENT MANAGEMENT* 75-85 (1989).

50. See JOCK BRUCE-GARDYNE, *MRS. THATCHER'S FIRST ADMINISTRATION* 84, 85 (1984).

51. NIGEL LAWSON, *THE VIEW FROM NO. 11: BRITAIN'S LONGEST-SERVING CABINET MEMBER RECALLS THE TRIUMPHS AND DISAPPOINTMENTS OF THE THATCHER ERA* 401 (1993). Note the similarity of these sentiments to those underlying the 1933 and 1934 securities laws in the United States.

52. *Id.*



and 600 amendments. It had been drafted by lawyers and bureaucrats, and practitioners found it a nightmare even to understand, let alone implement.<sup>53</sup>

The centerpiece of the FSA was the establishment of a new regulatory structure. At the top was the Securities and Investment Board (SIB), a quasi-governmental body accountable directly to the Secretary of State for Trade and Industry. It consisted of both practitioners and bureaucrats. The SIB was a constitutional novelty. It was financed by levies on the private financial firms it regulated, but was not accountable either to them or Parliament. Instead, the Director-General of the SIB was appointed by, and was answerable to, the Secretary of State for Trade and Industry. It had the power to make rules and award or revoke licenses for securities firms; but, unlike the SEC, it had no independent power to fine or punish. The most it could do was to bring cases of criminal wrongdoing to the attention of the Crown Prosecution Service, which could then bring charges.

All investment firms had to be authorized and organized into one of a number of "self-regulatory bodies" (SROs), which were, in turn, accountable to the SIB.<sup>54</sup> The FSA required any firm wishing to conduct financial services to register with one of the SROs or with the SIB directly. The SROs were responsible for drawing up and overseeing rules concerning business practices in their respective fields. It was their responsibility to ensure compliance with SRO-based rules and with those of the higher authority, the SIB. They did this by requiring their registered firms to provide personnel to act as practitioner-regulators. The SROs were manned chiefly by private employees on secondment, and each individual firm was required to hire at least one in-house "compliance officer." In short, the new system of "practitioner-based regulation in a statutory framework"<sup>55</sup> was comprehensive but cumbersome. The costs of the new structure were to be born by the industry, most directly by the payment of fees to the SROs.

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53. Interview with Fabio P. Savoldelli, Fund Manager at Bank of Tokyo International, London, in London, England (July 1993). See C. Makin, *First Big Bang, Now Big Brother*, INSTITUTIONAL INVESTOR, May 1988, at 58-67 (showing how the industry viewed the new regime).

54. Initially there were five SROs. The Investment Management Regulatory Organization (IMRO) represented all of the larger and some of the smaller, but more prestigious fund managers. The Association of Futures Brokers and Dealers (AFBD) represented futures brokers and dealers. The Financial Intermediaries, Managers, and Brokers Regulatory Association (FIMBRA) represented the small operators, typically those serving retail clients. The Life Assurance and Unit Trust Regulatory Organization (LAUTRO) represented the insurers and unit trusts, the British equivalent of mutual funds.

55. This phrase was given to me by James Ekins, Director, IMRO.

The unusual hybrid nature of the SIB owes much to the uneasy compromise with which it was born. On the one hand, Gower was known to favor a strong and central regulator modeled along the lines of America's SEC. On the other hand, the Conservative Government was known to be ideologically hostile to any extension of government that could be avoided: certainly the creation of a large bureaucratic agency was unlikely to be welcomed by the Thatcherites. The City was generally thought to prefer self-regulation where possible, however, there is also evidence that some in the City were in favor of a greater degree of regulatory oversight. "The Governor's Group," a think-tank, appointed by the Governor of the Bank of England and consisting of ten prominent City figures, including London Stock Exchange Chief Nicholas Goodison, were asked to look into the feasibility of continued self-regulation. Reportedly, they concluded that self-regulation could work, but only with beefed-up statutory underpinnings. A minority even suggested that the Bank of England (Bank) take over the role of stock market regulation.<sup>56</sup>

The Bank, however, was ambivalent. It was reluctant to see the establishment of an SEC-type body that would clearly undercut its preeminence as the chief overseer of London's financial markets.<sup>57</sup> On the other hand, the Bank was reeling under criticism from its failure to prevent the collapse of Johnson-Matthey Bank. An example of the type of rhetoric employed against the Bank is provided by the following Parliamentary exchange. Labour Party Member of Parliament (MP) Mr. Brian Sedgemore argued that the Johnson-Matthey banking scandal arose from "the wanton and negligent behaviour of [Governor of the Bank of England] Mr. Robin Leigh-Pemberton. . . . How can anyone trust a system of supervision organized by that appalling deadbeat?" To this, Nigel Lawson, Conservative Chancellor of the Exchequer, replied: "To call Mr. Sedgemore a pest would be an insult to pests;" in turn prompting Sedgemore to call Lawson a "sniveling little git."<sup>58</sup>

Many Bank officials believed that future collapses and scandals were inevitable and that, as bankers, they did not necessarily have the expertise to prevent such problems from occurring in securities markets. A new regulatory body with specific responsibility for oversight, but deliberately kept less

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56. MARGARET REID, *ALL-CHANGE IN THE CITY* 246 (1988).

57. ANTHONY HILTON, *CITY WITHIN A STATE: A PORTRAIT OF BRITAIN'S FINANCIAL WORLD* 31 (1988).

58. INSTITUTIONAL INVESTOR, June 1986 (quoting a Parliamentary Debate, Dec. 17, 1985). A "git" is a relatively modern British term of abuse approximately equivalent to the American expression "jerk."

powerful than the Bank, could be an ideal way to divert political criticism from the Bank ahead without compromising its position. With these issues in mind, the Bank's Governor reportedly accepted the idea of the SIB; and, calling in turn on the heads of all of the major banks, he "ordered the City to do likewise."<sup>59</sup>

Needless to say, financial firms complained bitterly about the costs of these new rules. The real losers of the FSA were the unscrupulous or the incompetent, and they faced difficulties in mobilizing politically. But all firms were potentially hurt, not just with the direct costs of compliance, but in terms of lost business, reduced competition, and stifled innovation as the onerous new requirements scared away new participants, especially foreign ones. David Lomax, economic advisor to National Westminster Bank, wrote that "one of the main threats to the future health of the financial services industry in the UK is that of excessive or inappropriate legislation."<sup>60</sup> He calculated that the direct costs to the City of the Financial Services Act were in the order of £100 million.<sup>61</sup> Charles Goodhart, of the London School of Economics, wrote that the "overregulation" was in response to "a series of minor but well-publicised scandals."<sup>62</sup> Arguing that since the regulators did not have to bear the burden of costs, but did have to face political flak in the event of scandals, the lengthy and detailed SIB rule book "seems not to have left reasonable investor protection at a minimum."<sup>63</sup> Moreover, there was little concern with limiting the costs of regulation. Indeed, costs had been deliberately excluded from Gower's terms of reference.<sup>64</sup>

Such apparent disregard for London's competitive position, or for the preferences of the biggest brokers and investors, scarcely accords with the explanation of Big Bang that stresses that competition was the driving force for change. It could, perhaps, be objected that there is little hard evidence that London, as a financial center, suffered from the terms of the FSA. Ten years later, it is still the preeminent financial center in Europe. On the other hand, as Grilli argues, given the "thick externalities" associated with being a

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59. HILTON, *supra* note 57, at 32.

60. DAVID F. LOMAX, LONDON MARKETS AFTER THE FINANCIAL SERVICES ACT 202-37 (1989).

61. *Id.* at 198.

62. C.A.E. GOODHART, THE CENTRAL BANK AND THE FINANCIAL SYSTEM 450 (1995).

63. *Id.* at 451.

64. Charles Goodhart, *The Economics of Regulation*, in FINANCIAL REGULATION OR OVERREGULATION? 15, 21 (Arthur Seldon ed., 1988).

financial center, it is possible that London maintained its preeminent international role not because of but in spite of the terms of the FSA.<sup>65</sup>

A more telling counter-argument is that, since the FSA was passed, it has been continuously watered down in the face of ongoing attacks from the City. Most telling is the replacement of the first head of the SIB, Sir Kenneth Berrill, with David Walker. Berrill, described by Nigel Lawson as "somewhat peripatetic," was held responsible for the SIB's overly bureaucratic approach.<sup>66</sup> He was not reappointed in 1988. David Gowland writes that he "was effectively sacked."<sup>67</sup> His replacement, David Walker of the Bank of England, was a popular City choice thought to herald "a move to a less onerous system of regulation."<sup>68</sup> According to Lawson, "While the regulatory system ushered in by the FSA still suffers from a number of its early defects, there has been a considerable improvement and simplification since the Government and the Bank replaced Berrill as SIB chairman in 1988 with the Bank's David Walker."<sup>69</sup> The trend of appointing chief regulators more sympathetic to the needs of large City institutions continued when Walker was replaced by Andrew Large, who had a City background as a practitioner in the Euromarkets.

Official pronouncements from the regulators themselves, that the FSA was backfiring on the City, provided further evidence that the original FSA went too far in the direction of investor protection. As expected, the regulatory authority most closely charged with ensuring the profitability of the City, the Bank, was most vociferous in its cost-consciousness. The Governor remarked in 1989:

I am very conscious of the costs that have been, and continue to be, involved in regulation and therefore welcome not only the SIB's simplified rulebook but also the Secretary of State's acknowledgment of these costs and his intention to amend legislation accordingly. We shall need to remain vigilant in striking the balance between the protection of investors and the costs imposed on the activities of financial firms if

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65. See Vittorio Grilli, *Europe 1992: Issues and Prospects for Financial Markets*, ECON. POL'Y, Oct. 9, 1989, at 394.

66. LAWSON, *supra* note 51, at 399.

67. DAVID GOWLAND, REGULATION OF THE FINANCIAL MARKETS IN THE 1990S 92 (1990).

68. *Id.*

69. LAWSON, *supra* note 51, at 402.

London's competitiveness is not to be eroded and "regulatory arbitrage" . . . is not to become a criterion in decisions on where to conduct business.<sup>70</sup>

In other words, the producers of financial services either opposed the passage of the FSA in its current form and are still struggling to modify its terms; or in the case of the crooks that the FSA was designed to thwart, they were unable to lobby. There is little evidence that big customers took sides at first. Later on, they too threw their weight behind the efforts of the intermediaries to rewrite the FSA to allow far greater freedom of action in trades between professionals.<sup>71</sup> This leaves only the government or small customers as potential supporters of the FSA. Clearly, the latter were the intended beneficiaries, but, surprisingly, there does not appear to have been any large or well-coordinated campaign by small investors to get more protection.<sup>72</sup> Pressure from small investors appears to have worked indirectly, if at all. Is this, then, a case of political entrepreneurship on behalf of the Thatcher government? This certainly seems to be part of the explanation. We have seen that they were anxious to avoid the stigma of being "soft on the City," and it is significant that the City, too, recognized the political dangers. The big firms waited until *after* the 1987 election before launching their big lobbying campaign against the FSA.<sup>73</sup> Yet this is not the whole story. As seen from Lawson's comments above, the original FSA did not meet with Conservative approval, and its history has been one of constant amendment. Another part of the explanation, then, must be that the drafters of the Bill, who were Treasury bureaucrats and lawyers, were insulated from the lobbying efforts of the City and of the ruling party, and drafted an act with reference exclusively to prudential problems as they perceived them. Unfortunately, their perceptions did not necessarily mirror the reality of such problems. It was in this insulated form that the FSA went before Parliament, and it has been amended to better suit the larger investors ever since.

The FSA has not ended fraud in the City, and in fact appears to have done a particularly bad job of protecting smaller investors. Both BCCI and the Maxwell pension fund scandals, in which small retail savers and pension fund

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70. *Monetary Policy, Equity Markets and the City's Infrastructure*, 29 BANK ENG. Q. BULL. 529, 530 (1989).

71. Interview with Nils Taube, Partner, Kitcat and Aitkins (May 11, 1990).

72. See GOODHART, *supra* note 62, at 433-34.

73. REID, *supra* note 56, at 251.

holders were the main victims, were precisely the sorts of things the FSA tried to prevent. The Maxwell scandal is particularly interesting: the whole premise of the FSA was investor protection, with the assumption that the potential crook is always the intermediary. The FSA did not envisage that the investor himself would be dishonest, and there were no rules allowing for this contingency. It was through this loophole that Robert Maxwell managed to squeeze himself.<sup>74</sup> The BCCI scandal appears to have been an abject failure of oversight on behalf of the Bank. An extremely cynical explanation for the failure of oversight in the BCCI case is that regulators do not have the resources to oversee more than a small proportion of their mandate and must select those on whom to focus their attention. Not surprisingly, they concentrate mostly on intermediaries who deal with domestic clients. They are less concerned politically if foreign investors, even under their jurisdiction, are being ripped off. This may explain the impunity with which investment managers in London routinely broke the most important rules of the FSA and the Investment Management Regulatory Organization (IMRO).<sup>75</sup> BCCI may provide an example of this phenomenon.<sup>76</sup>

The inability of the new structure to protect small investors appeared to be so endemic that in 1993 the Treasury commissioned bureaucrat Sir Kenneth Clucas to investigate retail investor protection. His recommendation was that the SIB establish a new SRO specifically for retail investors. The new SRO would comprise a merger of LAURTRO, FIMBRA, and those parts of IMRO

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74. Interview with James Ekins, Director, IMRO in London, England (July 10, 1992).

75. In this vein it is instructive to consider two of the most spectacular incidents of financial dishonesty in recent times: first, the collapse of Barings Bank due to huge losses on unauthorized futures trades in Singapore in 1994; and second, the revelation in 1995 that Daiwa Bank's American subsidiary lost over \$1 billion in unauthorized futures trades in New York. Both were not just the result of a financial firm's overseas subsidiary acting illegally, but the local regulators completely overlooking the problem, even though it was legally their responsibility. It is hard to imagine that an American bank in New York could cover up millions of dollars worth of losses for over eleven years, as Daiwa was able to do. See Keith Bradsher, *U.S. Concedes Lax Response in Daiwa Case: Greenspan Says the Fed Studies Tougher Rules*, N.Y. TIMES, Nov. 28, 1995, at D1.

76. Certainly this was the view of Labour MPs such as Roy Hattersley, who pointed out that the British victims of the BCCI collapse were concentrated among the South Asian immigrant populations who were chiefly of Pakistan origin in inner cities such as Birmingham, and who had turned to BCCI because of its greater concern for immigrants' business. He argued, in effect, that racism or at least a studied indifference toward the well being of this section of the population was behind the Bank's disregard of warning signs about BCCI's affairs. See Neil Buckley, *Tragedy for Asian Traders*, FIN. TIMES, July 8, 1991.

and the new Securities and Futures Association (SFA)<sup>77</sup> which represented private clients. The result was the proposal of a Personal Investment Authority (PIA) in 1992 with intense criticism from the big banks and life insurers.<sup>78</sup>

Even this did little to assuage public complaints that small investors and savers were not adequately protected by the new regime. The most recent source of criticism came from a SIB report on personal pensions, a £4 billion industry, that concluded that in over one and a half million cases, investors were wrongly advised by firms. The SIB came under criticism from consumer groups, Trade Unions, and Labour MPs for its failure both to protect individuals or adequately to punish corporate wrong-doers. Alistair Darling, Labour's City spokesman, was reported as saying that "[t]he regulators must . . . act for the public good."<sup>79</sup>

The continued failure of the new regulatory regime adequately to represent small investors was demonstrated by the founding of a new pressure group, The Guild of Shareholders, in 1995. Its founder was a former Conservative MP, Tom Benyon; and its goal was to ensure better representation for small investors on company boards. The last straw had been a fight during the 1995 British Gas annual meeting, when private shareholders had attempted to block what many believed to be the excessive new pay package for Chief Executive Cedric Brown. The attempt had been beaten by the proxy votes of institutional investors. According to Benyon, "[t]he Guild is banding private shareholders together in a lobby big enough to stop them [from] being pushed around."<sup>80</sup>

In contrast to the failure of the regulatory authorities effectively to oversee the retail markets, British regulators have been extremely conscientious in their attempts to stamp out financial fraud where big institutional investors and liquidity traders rather than small savers are the real victims.

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77. The SFA was created by the merger of the securities and futures regulators in 1992, themselves creations of mergers from the original SROs.

78. *Self-Regulation's Last Stand?*, *ECONOMIST*, Dec. 5, 1992, at 77.

79. Robert Miller, *SIB Accused of Weak Stance in Pension Scandal*, *TIMES*, Jan. 17, 1996, at 23.

80. Colin Narbrough, *Private Shareholders Promised More Clout*, *TIMES*, Aug. 28, 1995, at 36.

VI. JAPAN: THE SECURITIES AND EXCHANGE  
SURVEILLANCE COMMISSION, 1991

Modern Japanese financial regulations were drawn up by the Allied occupation forces (SCAP) in 1946 and were closely modeled on existing U.S. law.<sup>81</sup> The Securities and Exchange Law (SEL) of 1947 governed the issuance and trading of stocks and bonds. The law closely followed U.S. practice on many points. Most importantly, Article 65 copied the Glass-Steagall Act's separation of investment and commercial banking and established the Securities Commission for the Supervision of Securities Business as a direct equivalent agency to the SEC. The Japanese commission, like its American counterpart, was independent of other agencies or political control and was entrusted with the administration of the 1947 law. Although both the United States and Japan began post-war life with almost identical financial regulations on paper, securities markets in the two countries were soon to develop along very different trajectories. The break came in 1952 with the "Reverse Course" of occupation policy in Japan. SCAP, worried by the advent of the Cold War and anxious both to prevent Communist or Socialist influence from gaining ground in Japan, and to build Japan's economic strength as quickly as possible, had begun to draw back from the "New Deal" progressivism of its earlier reforms. This left Japanese bureaucrats quietly but firmly to reestablish the control over economic life that they held before World War II. One of the first casualties of the Reverse Course was the Securities Commission. It was abolished by the Ministry of Finance (MOF) in 1952 and replaced with an internal advisory council to the Securities Bureau, which had no independent powers. The MOF arranged the abolition because it wanted to regain control over *all* aspects of financial regulation.<sup>82</sup> At the same time, the MOF abolished various other articles designed to establish American standards of business practice. Among those scrapped was Article 189, an equivalent of the SEC's Rule 16(b) which constrains "short-swing trading" and therefore inhibits the practice of insider trading.

The divergence between Japanese and American financial regulation grew more and more stark over the next thirty years. One of the most significant areas of difference involved supervision. In the United States, regulatory authority was fragmented among many different agencies, and investor

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81. See ELEANOR M. HADLEY, *ANTITRUST IN JAPAN* (1970).

82. See T.F.M. ADAMS & IWAO HOSHII, *A FINANCIAL HISTORY OF THE NEW JAPAN* 52 (1972).



protection was provided by an agency, the SEC, which had no divided loyalties and plenty of power to do its job. The result was that the SEC did a reasonably good job of protecting investors from unscrupulous brokers within the securities industry. In Japan, regulatory authority was highly centralized within the MOF, which was responsible for both promoting the interests of the securities industry and for ensuring investor protection. When the two goals came into conflict, the MOF would almost invariably side with the brokers. The Securities Bureau was so partisan that many Japanese bankers referred to it as “the Toranomon branch of Nomura Securities.”<sup>83</sup> The resulting Japanese securities markets were so rife with dubious practices that the Tokyo Stock Exchange acquired the nickname “*insaida tengoku*” or insiders’ paradise.<sup>84</sup>

This state of affairs did not seem to trouble politicians, bureaucrats, or the general public. The “Bubble Economy” of the mid to late 1980s saw prices on the Tokyo stock market soar, and Japanese investors were apparently happy to overlook abuses by brokers as long as everyone was making money. However, in the late 1980s, a series of financial scandals shook the country and changed public attitudes dramatically.

In 1987, Tateho Chemical Company engaged in highly speculative bond futures trading and incurred losses of over ¥23 billion.<sup>85</sup> The Tateho’s main bank, Hanshin Sogo, sold its entire holding of Tateho stock the day before the losses were made public and the share price collapsed. This clear abuse of privileged information provoked a public outcry, but the Osaka Stock Exchange was unable to establish that Hanshin had broken any rules.<sup>86</sup>

In 1988, the Recruit Company admitted that it had been bribing politicians by giving them cheap shares in an unlisted subsidiary, Recruit Cosmos. When the subsidiary was listed, the shares immediately and predictably rose in value. The list of those who had received these shares included the private secretaries

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83. At the bottom of this symbiotic relationship was the *amakudari* system, whereby Japanese bureaucrats would retire to take up lucrative private sector jobs. MOF officials, in common with most Japanese bureaucrats, were poorly paid and the prospect of retirement to a wealthy securities firm was an attractive one: the regulators thus had strong personal incentives not to rock the boat by investigating those same firms.

84. NIHON KEIZAI SHIMBUNSHA, *INSAIDA TENGOKU: KENSHOO NIHON KABUSHIKI SHUJO [INSIDER’S PARADISE: THE JAPANESE STOCK MARKETS]* (1988) (documenting the widespread practice of insider trading in Japan).

85. In the 1980s, most Japanese corporations were finding that speculation in the financial markets a process known as *zaiteku*, or financial engineering, was often more profitable than their core businesses.

86. See GURUPU NE, *INSAIDA TORIHIKI NO NAIMUKU [INSIDE INFORMATION ON INSIDER TRADING]* 22-38 (1988).

Takehita Noburu, who resigned over the affair, and Minister of Finance Miyazawa Kiichi.<sup>87</sup>

In 1991, the four biggest Japanese securities companies, Nomura, Daiwa, Nikko, and Yamaichi, admitted that during the 1980s they gave illegal guarantees of a set rate of return on funds entrusted to them by favored clients.<sup>88</sup> When the Tokyo stock market crashed in 1990,<sup>89</sup> the brokers had made good on their guarantee by compensating their preferred clients, while less favored investors lost fortunes. Suspicions grew that the MOF had been aware of this morally dubious practice but had done little to prevent it.<sup>90</sup> The brokers' unsavory reputation was not helped when, at around the same time, Nomura admitted that it had been lending money to a *Yakuza* (gangster) boss to help him manipulate the share price of Tokyu Railway Corporation. The lost compensation scandal provoked such an intense barrage of criticism that it served as the catalyst for far-reaching reforms of the Japanese regulatory structure for financial markets.

The scandals of 1991 created an uproar in Japan. The most shocking aspect of the affair for many was the evidence that the MOF had known all along about the various abuses, but had done nothing to prevent them.<sup>91</sup> Indeed, it was only when the National Tax Agency acted that the scandal broke at all. The Securities Bureau was perceived as having no role in exposing the scandal. According to the *Nihon Keizai Shimbun*:

The scandals were generated by a combination of factors—the absence of competition (which leads to excessive profits), legal laxity against fraudulent trading, ambiguous rules and a poor surveillance system. Common to these factors is an administrative policy that gives top priority to protecting and fostering the industry in a close symbiotic relationship between bureaucrats and business. Given such a state of

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87. See BRIAN READING, *JAPAN: THE COMING COLLAPSE* 263-67 (1992); ASAHI SHIMBUN, TAKEHITA SEIKEN NO HOKAI: RIKURUTO JIKEN TO SEIJI KAIKAKU [THE FALL OF THE TAKEHITA ADMINISTRATION: POLITICAL REFORM AND THE RECRUIT INCIDENT] (1989).

88. OKUMURA HIROSHI, SHOKEN SUKANDARU [STOCK SCANDAL] (1993) (covering the scandal); see also CHRISTOPHER WOOD, *THE BUBBLE ECONOMY: THE JAPANESE ECONOMIC COLLAPSE* 118-26 (1992).

89. The Nikkei 225 index fell 39% during 1990.

90. Technically it was not actually illegal for a broker to compensate some clients but not others for losses, although this practice did breach an MOF directive of 1989. It was, however, illegal to guarantee a set rate of return on an investment fund.

91. Steven R. Wiesman, *Oversight Plan Loses in Japan*, N.Y. TIMES, Sept. 14, 1991, at L35.

affairs, *the only recommendation should be for a complete separation of a watchdog body from bureaucratic control . . . . [Which] should be given as wide-ranging authority as possible.*<sup>92</sup>

The scandal also drew attention to the low priority that the MOF put on market oversight. The entire securities industry was monitored for fairness by only thirty or so staff from the Securities Bureau.<sup>93</sup> The Tokyo Stock Exchange had around thirty more staff in its surveillance division, while the other self-regulatory organization, the Japan Securities Dealers Association, had no monitoring function.<sup>94</sup> This lack of resources would have made it very difficult for the authorities adequately to police the markets even if they were genuinely committed to doing so—a commitment which many people doubted in any case.

By July 1991, public uproar over the scandal was so great that the ruling Liberal Democratic Party (LDP) felt compelled to act. Prime Minister Toshiki Kaifu formed a government advisory panel to review the system of regulatory reform including the possibility of establishing a financial watchdog similar to the SEC. This panel, the Ad Hoc Commission on Administrative Reform (Reform Commission), contained nine members drawn from business, labor, and academic circles. Eiji Suzuki was appointed Chairman. He was a former chairman of the Japan Federation of Employers' Associations (*Keidanren*) and was known to favor the creation of an independent, SEC-style agency. Also on the Reform Commission were union leaders Eikichi and Ashida, who were both also enthusiastic proponents of radical change in the way the markets were policed. Again, both were known to favor an independent, SEC-type regulatory agency.

The senior ranks of the LDP supported the initiative to create an independent agency to monitor the securities industry. In July 1991, LDP Secretary-General Obuchi Keizo said that such a body should be considered as part of an effort to prevent the recurrence of the compensation scandal. "Japan's political and administrative systems must be changed so that they can be accepted by the international community," Keizo told a meeting of the

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92. *Securities Watchdog Should not be Muzzled*, NIKKEI WKLY., Sept. 14, 1991, at 6 (emphasis added).

93. Interview with MOF official, in Tokyo, Japan (Feb. 23, 1994).

94. Interview with Taka Okada, Manager, International Department, Japan Securities Dealer Association, in Tokyo, Japan (Feb. 24, 1994).

LDP.<sup>95</sup> Nishioka Takeo, Chairman of the LDP's Executive Council, referred to the scandal and said that "self-responsibility" must be respected. Given Japan's status as the second-largest economic power, Japanese business should be conducted in accordance with "common rules" within the international community. In addition, "establishing conditions for fair competition in a free-market economy is the responsibility of politicians."<sup>96</sup>

Indeed, most of the debate over the new agency centered on how similar to the SEC the Japanese version should be. Most people outside the securities industry and the MOF strongly favored an American-style agency.<sup>97</sup> The heads of all of the major business organizations supported this idea. These supporters included Suzuki of Keidanren; Hayami Masaru, Chairman of the Japan Association of Corporate Executives; and Nagano Takeshi of Nikkeiren, the Japan Federation of Employers' Associations.<sup>98</sup> The idea also had support from the Japanese Trade Union Confederation and the Democratic Socialist Party. Bank of Japan advisor Suzuki Yukio wrote that "Japan does not act promptly enough to prevent shady stock market transactions . . . . What Japan needs is a strict regulatory body like the US Securities and Exchange Commission."<sup>99</sup>

Missing from the debates about the new agency were the voices of the powerful securities companies, especially the "Big Four." Their reluctance to take too prominent a position was entirely understandable given the companies' extreme unpopularity and the intense scrutiny to which they were then subject. As new revelations about their nefarious activities emerged, seemingly daily, they could do little more than hunker down and wait for the storm of protest to subside. A senior official at one Big Four company explained that "of course the securities companies hated the new regulations. We didn't like the SESC . . . but at the time we had no influence because of the scandals."<sup>100</sup>

The MOF opposed the creation of a new agency. This position had the solid support of Finance Minister Hashimoto Ryutaro, who was extremely sympathetic to the Ministry. He said, "[t]he securities industry is not so

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95. *Calls Are Mounting for Broker Watchdog*, JAPAN TIMES, July 5, 1991.

96. Masaki Itagaki & Hisane Masaki, *Diet May Force Ministry to Act*, JAPAN TIMES, July 29, 1991.

97. See KEIICHI OKUMURA & HIDETAKA KAWAKITA, NIHON NO KABUSHIKI SHUJO 201-09 (1992) (discussing the debate).

98. Clay Chandler, *Japan Finance Ministry's Hasher Tone Suggests New Suspicions of Wrongdoing*, WALL ST. J., Sept. 3, 1991, at A14.

99. Yukio Suzuki, *A Time for Soul-Searching*, JAPAN TIMES, July 9, 1991.

100. Interview with Securities Company official, in Tokyo, Japan (Mar. 1994).

troubled as to need a watchdog like the SEC"<sup>101</sup> and later claimed that the creation of the agency entailed "much pain" to the Ministry.<sup>102</sup> The staff of the Reform Commission, drawn from the ranks of the MOF itself, also helped the MOF's cause. The director of staff for the Commission, Masujima Toshiyuki, was a senior official in the MOF's Management and Coordination Agency. What resulted was a battle between the reformers on the Commission, who wanted real change, and the MOF staff on the Commission, who were determined not to give away any more power than they had to.<sup>103</sup> Secret meetings with the Finance Minister, impossible deadlines, and bureaucratic pressures were some of the tools used by the MOF to water down the most far-reaching proposals.<sup>104</sup>

The decisive event in the MOF's defense of its turf came in September 1991. Commission Chairman Suzuki stated at a public news conference that he intended to make the new watchdog agency independent of the MOF. Shortly afterward, Finance Minister Hashimoto Ryutaro met first with Suzuki and then, in secret, with staff director Masujima. After that meeting, Masujima began aggressively to argue against the idea of an independent body and is quoted as saying that "[a]ny new organization has to be in harmony with the existing structure."<sup>105</sup> His arguments began to sway the members of the Commission, who were already under pressure to meet the September 13th deadline to make the final report to Prime Minister Kaifu.

By early September, all the Reform Commission members except the two union leaders had agreed to a compromise solution whereby the agency would be nominally autonomous but operated under the auspices of the MOF. To achieve compromise, Magara and Ashida agreed to allow the agency to operate within the MOF only if it had the twin powers to order a stop to securities laws violations and to punish offenders unilaterally. The other members of the Commission agreed to this compromise, and the two provisions appeared on the draft given to Commission members for review on September 11th. When the final draft appeared before the Council for the vote, however, the two provisions were gone, obviously removed by the MOF

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101. *Calls Are Mounting for Broker Watchdog*, *supra* note 95.

102. *Rearguard Action*, *ECONOMIST*, Sept. 7, 1991, at 76.

103. *Nihonhan SEC Mikomaru* [A JAPANESE-VERSION SEC LOOKS IN TROUBLE], *YOMIURI SHIMBUN*, July 6, 1991, at 9.

104. James Stemgold, *Japanese Learn Lesson in Bureaucratic Rule*, *N.Y. TIMES*, Nov. 4, 1991, at D3.

105. *Id.*

staff. There was no time to make further amendments, and the draft presented to the Prime Minister was, therefore, considerably weakened even from the watered down compromise agreed by the Commission. Masujima admitted that his staff had removed the provisions, claiming that "[t]here was such limited time that, in the end, the most persuasive line had to be included in the report."<sup>106</sup>

The Reform Commission reported back in September 1991 with a report on Basic Measures to Rectify Unfair Securities and Financial Dealings. It addressed four separate matters. First, it reviewed current administrative practices and explored measures to ensure greater transparency. Second, it looked to strengthen the functions of the industry's self-regulatory bodies. Third, it examined the way surveillance and inspection should be carried out. Finally, it established the principle of self-responsibility for investors.<sup>107</sup> In connection with the third point, it recommended the creation of an independent watchdog *within* the MOF and the concomitant reorganization of the various inspection agencies already existing within the Ministry.<sup>108</sup>

Based on these recommendations, the MOF set up a special panel to study the securities and financial monitoring system "canvassing views from many sectors and considering the matter in the widest perspective" as they themselves claimed.<sup>109</sup> This included visits by the MOF to the SEC in order to better understand how the Americans dealt with financial irregularities.<sup>110</sup> The result was a bill partially to amend the SEL, drafted in February 1992. The bill was approved by the Diet in May 1992 with implementation set for July 20, 1992.

The SESC is composed of a chairman and two commissioners, who are appointed to three-year terms by the Minister of Finance, subject to approval by the Diet.<sup>111</sup> Except under specific exceptional circumstances, their status is guaranteed and they cannot be discharged. The first Chairman, Mizuhara Toshihiro, came from a career in the Public Prosecutor's Office. It was a significant and deliberate decision to appoint someone outside the MOF as the first chairman. Of the two commissioners one, Narita Masamichi, came from

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106. *Id.*

107. Especially note the parallels to the American laws of 1933 and 1934, which also stressed transparency and self-responsibility as the best mechanisms for investor protection.

108. *Ministry Plans Its Own In-House 'SEC,'* DAILY YOMIURI, Aug. 11, 1991, at 8.

109. Sei Nakai, *The Current State of Affairs of the SESC*, KINYU J. 43, 44 (1993).

110. *Officials to Visit SEC*, DAILY YOMIURI, Aug. 11, 1991, at 8.

111. See Securities and Exchange Surveillance Commission, *Outline of Activities* (1992).

a career at NHK, the Japanese public television company, where he had been Chief Commentator. The other commissioner, Mihara Hidetaka, was another bureaucrat; he was the former Secretary-General of the Board of Audit. As of 1992, there were 202 staff, 84 in Tokyo and 118 in regional offices, although around half of the regional staff were assigned to the monitoring the Tokyo Stock Exchange.

The powers of the SESC are not nearly as great as those of the SEC. It can investigate suspicious trading, but has few independent powers beyond those to recommend action to the MOF or the Public Prosecutor's Office. Unlike the SEC, the SESC has no independent power to penalize market participants for abuses of laws nor does it have subpoena power when it is conducting investigations or enforcement actions. The Inspection division is authorized to probe into suspicious cases, but does not have the right to bring prosecutions. Instead, it may make accusations of suspected crimes to the Public Prosecutor's Office, which retains the right to bring cases to court. It may obtain a court order to search target premises and seize evidence. The SESC may recommend that the Minister of Finance take disciplinary action against a company it suspects of wrongdoing, and the Minister is obligated to respect this recommendation and report back to the SESC on any disciplinary actions taken. It can, moreover, make policy recommendations to the Minister.

In Japan, the initial response to the SESC was frustration that the MOF had prevented more radical reform. Magara Eikichi stated that "there is no question the Finance Ministry used its power, officially and unofficially, to make sure this new body was under its influence."<sup>112</sup> The point was not lost on the Japanese press or public: "It is sad to admit that Japan is a country by bureaucrats, of bureaucrats, and for bureaucrats," stated the *Yomiuri Shimbun*.<sup>113</sup> The *Nihon Keizai Shimbun* argued that "[a]ll through this mess the Finance Ministry has done nothing more than seek to defend itself. There are no signs that ministry officials feel responsibility for the scandals which were invited in part by their close relations with securities firms."<sup>114</sup> According to Kyoto University Economics Professor Sawa Takemitsu, "the Ministry of Finance ended up with what they wanted. In fact, the whole interdependence

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112. Sterngold, *supra* note 104, at D3.

113. *Id.*

114. *Id.*

of the Government Bureaucracy and the securities industry will end up even stronger than it was before."<sup>115</sup>

However, this pessimism now looks overstated. The criticisms that the SESC is neither as powerful nor as independent as the SEC are disputed by the Commission itself. According to Secretary-General of the Executive Bureau, Ishizaka Masami:

Some critics contend, erroneously, that the SESC of Japan has little power, but it, in effect, has as much criminal investigative powers as the SEC has. For example, Japan's Commission, if armed with a court warrant, can enter the premise of a suspect and conduct compulsory investigation. In this sense, I have the feeling that Japan's Commission, legally speaking, has stronger power than its US counterpart. The SEC has no power to conduct compulsory investigations, such as the power to seize evidence. It can only subpoena witnesses or order them to submit evidence.<sup>116</sup>

Subsequently, there has been much comment on how short-staffed the Agency is relative to its American counterpart. The observation that its staff numbers compared poorly to the 2600-odd staff of the SEC became so pervasive that SESC officials took to rebutting it formally. Ishizaka Masami, Secretary-General of the Executive Bureau, wrote that:

Some complain that with a ratio of 200 to 2,600, Japan's commission cannot hold a candle to the SEC. However, the comparison these critics make is based on a wrong number. As the number of staffs assigned to the Enforcement Division of the SEC is 800, not 2,600, the number of staffs of Japan's commission should be compared with 800 . . . . However the 800 enforcement officers of the SEC have to keep watch over 12,000 registered securities companies. By contrast, Japan's commission has only 200-odd licensed securities companies to ride herd on. When the two are compared in this light, our

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115. Wiesman, *supra* note 91, at L35.

116. Ishikawa Masami, *The Course of Action Planned by the Securities and Exchange Surveillance Commission*, CAMRI, at 20 (Oct. 30, 1992).



Commission is not so underhanded as these critics would have us believe.<sup>117</sup>

Many critics were deeply unhappy that the MOF had apparently managed to retain control over the SESC. Significantly, the staff of the SESC go to considerable pains to stress the degree of independence they enjoy from the MOF and the securities industry. They cite the fact that all three commissioners were deliberately chosen for their lack of ties to either the ministry or the securities industry. Chairman Mizuhara bluntly stated, “[w]e will act independently of the MOF.”<sup>118</sup> Secretary-General Ishikawa Masami claims that “we are not at all controlled by the finance ministry . . . each institution has its own responsibilities.”<sup>119</sup> In interviews, staffers usually stress the fact of their independence, often citing the staff drawn from the tax agency as evidence of their commitment to objective and politically neutral law enforcement.

The performance of the SESC provides grounds for thinking that it takes its new role seriously. The agency disputes claims that it is too timid and weak and points to a growing series of successes in identifying and rooting out undesirable market practices. Since inauguration the SESC has launched a significant number of investigations. The Commission inspected 170 cases of irregular share-price movements in 1992-93 and 217 in 1993-94. In four of these cases, the inspections resulted in the SESC bringing accusations to the Public Prosecutor’s Office which resulted in court action and prosecutions.<sup>120</sup> In more than one case, the agency secured evidence by use of massive “dawn raids” on the offices of the suspects. The success of the raids in gathering evidence is cited as proof of the SESC’s effectiveness. “In reality, we have . . . much the same power as the American SEC,” remarked Director Nakai Sei in relation to the Nihon Unisys case.<sup>121</sup> There is, moreover, ample evidence that market participants believe the SESC is making a significant difference in the way that Japan’s financial markets are regulated. A managing director of a Japanese Investment Trust commented that “[t]he

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117. *Id.*

118. *Securities Watchdog Panel Inaugurated*, J. JAPANESE TRADE & INDUS., Oct. 1, 1991, at 5.

119. Robert Thomson, *Japanese Watchdog Aims to Silence Wagging Tongues*, FIN. TIMES, Mar. 30, 1993.

120. These cases were Nihon Unisys (market manipulation), Ipec (false disclosure), Nippon Shoji (insider trading), and Shimizu Bank (insider trading).

121. Jonathan Friedland, *Watchdog Cuts Its Teeth*, FAR E. ECON. REV., July 1, 1993, at 60.

Japanese stock market has been unclear to foreign investors because of speculative price movements. The commission's activities will keep the market clean."<sup>122</sup> The sentiment was echoed, albeit more cautiously, by the President of Fidelity Investments Japan, who remarked of the successful raids during the Nihon Unisys investigation that "it's a big step forward . . . but the Commission's still got a long way to go."<sup>123</sup>

In summary, the creation of the SESC is clear evidence that the Japanese have moved decisively, if incompletely, toward a more American style of financial regulation. The Japanese have accepted the principle, established in the United States in 1933-34, that fair markets are likely to be healthier and, therefore, of more value to society, than unfair ones. To that end, it is vital for the regulatory authorities to appear to be policing the markets in a vigorous and evenhanded fashion. This principle requires a greater degree of distance between regulators and regulated than Japanese bureaucrats had previously deemed desirable, and it also requires the application of public, formal sanctions where necessary. This represents a change from the previous belief that administrative guidance was all that was necessary to keep the markets functioning. It remains true, despite what the more enthusiastic SESC spokesmen might argue, that the SESC is not the all-powerful body that the SEC is, nor is it as politically independent. Nonetheless, this is clearly an area in which the Japanese have consciously emulated U.S. regulatory practices. The reasons for doing so were mixed. The demand for reform was primarily domestic, but the American model clearly influenced the debate within Japan. The SEC set a standard against which the Japanese measured their new agency. Moreover, the Japanese government was also prompted to act in part out of fear that foreign investors would shun a market which was as unfair and "rigged" as Tokyo appeared to be in the late 1980s.

#### VII. GERMANY: THE SUPERVISORY OFFICE FOR SECURITIES DEALING, 1994

Germany has a system of universal banking, which means that securities trading has never been considered a separate concern for regulators. The banking industry generally is exempt from antitrust law (*Kartellgesetz*) but is

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122. Makino Yo & Ikeya Akira, *Watchdog Raid Targets Illicit Speculation*, NIKKEI WKLY., Dec. 14, 1992, at 27 (quoting Takao Endoh, Asahi Investment Trust Management).

123. *Id.* (quoting Akamatsu Yasukazu, President of Fidelity Inv. Japan).

supervised by the Federal Cartel Office (*Bundeskartellamt*) and the Federal Supervisory Office for Credit Institutions (*Bundessamt für das Kreditwesen*). Historically, securities markets were much less important than bank lending as a source of corporate funds, although this situation began to change in the late 1980s. Each of the eight stock exchanges was responsible for ensuring fair play, which they did through a series of voluntary codes and minimal supervision. In 1993, Frankfurt had an insider trading commission of only six people.<sup>124</sup>

In July 1994, the German parliament passed the Financial Markets Promotion Act (*Finanzmarktförderungsgesetz*) (FMPA) in an attempt to bolster the status of Germany as a major international financial center, a concept known as *finanzplatz Deutschland*, and also to implement a number of European Community (EC) directives, including the requirement to ban insider trading. The FMPA established a new Federal Supervisory Office for Securities Dealing, the *Bundesaufsichtsamt für den Wertpapierhandel*, which was to be responsible for policing German securities markets and was to work in conjunction with the eight individual stock exchanges and the state governments. The FMPA also banned insider trading, for the first time in German history, and required companies to disclose any information that might affect stock or bond prices.

The German government appears to have taken this action under pressure from both domestic and international sources. Domestically, public opinion was growing less tolerant of insider trading; and in 1990s, Germany was shaken by a series of insider trading scandals. In 1991, the Frankfurt Stock Exchange uncovered an insider-dealing ring of about thirty brokers. In 1992, Deutsche Bank sacked a number of its staff for breaching internal rules prohibiting insider trading.<sup>125</sup> A much more serious scandal broke in 1993. Franz Steinkuhler was the head of IG Metall, a powerful engineering trade union with 3.5 million members.<sup>126</sup> Steinkuhler sat on the supervisory board of Daimler-Benz, and accordingly had access to confidential information. In March 1993, after a board meeting at Daimler-Benz, he bought large numbers of shares in a Daimler-owned company, Mercedes Holding Company (MAH). In April, Daimler announced that it was dissolving MAH and swapping the

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124. Frankfurt was easily the largest of the German exchanges, accounting for around 70% of securities trading in Germany.

125. David Waller, *A Tightening of the Rules*, GERMAN BANKING & FIN., May 31, 1994, at ii.

126. This membership made it the largest single union in the world. John Eisenhammer, *Fallen Fruit of Capitalism*, INDEPENDENT, May 30, 1993 (describing the scandal).

shares one-for-one with Daimler stock. The share price of MAH rose sharply, and Steinkuhler made a profit of over DM 100,000. In May, *Stern* magazine publicized his dealings, prompting a public outcry and demands for reform.

The IG Metall scandal was a particular embarrassment for the government because it came at a time when Germany was already facing international criticism for its delay in implementing the EC directive of June 1989 outlawing insider trading.<sup>127</sup> The directive had stipulated July 1992 as the deadline for all EC countries to ban the practice, but Germany had so far failed to comply. The delay appears to have been the result of feuding between Federal and state governments.<sup>128</sup>

The financial community was increasingly vocal in its demands for reforms to bring German regulatory standards in line with those of other countries. The bankers believed that Frankfurt's attractiveness to foreign investors was being badly harmed by its reputation for lax investor protection legislation. Hilmar Kopper, the head of Deutsche Bank, argued that legislation to ban insider trading "is clearly overdue and I cannot understand why it is taking so long."<sup>129</sup> A spokesman for Commerzbank A.G. said of the ban on insider trading, "[w]e, the big banks, have always favored this because it puts us on a par with the American and British markets. Markets today have to be geared to the international investor. Everyone wants to know they have the same protection in foreign markets that they have at home."<sup>130</sup>

Finance Minister Theo Waigel said that "[t]he confidence of domestic and foreign investors in how business is done is of considerable importance for the attractiveness of a financial center."<sup>131</sup> In addition to the competitive pressure to improve standards of regulation, the German banking industry also supported the idea of a securities and exchange commission because it could represent their interests at meetings of international securities regulators. International cooperation among securities regulators had become common during the 1980s and early 1990s, especially through the International Organization of Securities Commissions (IOSCO). The German securities industry was not represented at many of these meetings. This absence had

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127. *Id.*

128. David Waller, *Long Wait for German SEC*, FIN. TIMES, June 15, 1993, at 3.

129. John Eisenhammer, *Red Faces at Failure to Enact EC Law*, INDEPENDENT, May 30, 1993, at 6.

130. Ferdinand Protzman, *Germany Prohibits Insider Trading*, N.Y. TIMES, July 11, 1994, at D5 (quoting Dennis Phillips).

131. *Id.*

several negative repercussions. One such repercussion was that Deutsche Terminborse, a screen-based derivatives market, had found it difficult to obtain foreign recognition of its products.<sup>132</sup>

#### CONCLUSION: CONVERGENCE ON THE UNITED STATES MODEL?

Ten years ago, each of the four countries under discussion had a different set of regulations designed to provide investor protection. The United States relied on the SEC, a powerful supervisory watchdog to enforce regulations and oversee the markets. The SEC was independent of other agencies and faced no conflicts of interest. The British relied on a system of trust and integrity, and on the structural protection of single capacity on the stock exchange. The Japanese relied on informal supervision by a unified bureaucracy, but one that had multiple functions and divided loyalties. The Germans relied on the integrity of the universal banks. Over the past decade, the last three countries have all introduced agencies like the SEC. The result is that regulatory structures in all four countries are now much more similar to each other than they have ever been. This evidence, then, indicates a significant degree of policy convergence among countries where such convergence might not be expected.

In all four countries, however, the primary catalyst for reform was domestic politics: specifically, the failure of existing regulatory arrangements to prevent the exploitation of investors by financial firms. These failures produced financial and political scandals that prompted governments to introduce new and more stringent regulations. Each government created an agency devoted to the enforcement of the new regulations. However, the impact of financial internationalization was significant in shaping the responses of all countries except the United States. In Germany and Japan, existing arrangements for investor protection were so bad and so clearly rigged in favor of the powerful domestic financial intermediaries that foreigners were deterred from doing business in either country. Moreover, the overseas subsidiaries of Japanese companies suffered economic retaliation for the sins of their parent companies. For both reasons, globalization altered the cost-benefit calculus of the chief beneficiaries of inadequate investor protection regulation, local banks and brokers, in favor of improved regulation. In

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132. Waller, *supra* note 125.

addition, globalization made the SEC the regulatory model of choice. The other countries did not adopt the American model as a result of American coercion, but because of the power of example. The evidence, therefore, gives us reason to be optimistic about the beneficial side-effects of economic globalization.

