

POLITICS, BUREAUCRACIES, AND FINANCIAL MARKETS:
BANK ENTRY INTO COMMERCIAL PAPER
UNDERWRITING IN THE UNITED
STATES AND JAPAN

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Americans writing about Japan seem to fall into two camps: those who think the Japanese act according to very different rules than Americans, so that the apparent similarities between the two peoples actually mask deep cultural differences;¹ and those who think that the Japanese and the Americans are really rather similar, so that the obvious cultural differences cover more deep-rooted continuities.²

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¹ The classic cultural account of Japanese society is R. BENEDICT, *THE CHRYSANTHEMUM AND THE SWORD: PATTERNS OF JAPANESE CULTURE* (1946). See also T. DOI, *THE ANATOMY OF DEPENDENCE* (1973); C. NAKANE, *JAPANESE SOCIETY* (1970). Recent accounts by Western observers include J. MORLEY, *PICTURES FROM THE WATER TRADE* (1985), and P. TASKER, *THE JAPANESE: A MAJOR EXPLORATION OF MODERN JAPAN* (1987). A superb general treatment of modern Japanese history and society is E. REISCHAUER, *THE JAPANESE* (1977).

² The leading legal scholar who argues for deep-seated similarities between Japan and the United States is J. Mark Ramseyer. See, e.g., Ramseyer & Nakazato, *The Rational Litigant: Settlement Amounts and Verdict Rates in Japan*, 18 J. LEGAL STUD. 263, 290 (1989) (arguing that although culture is important, “the current emphasis on culture in comparative studies of Japanese law deflects attention from . . . mundane incentive structures”); see also Ramseyer, *The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan*, 94 YALE L.J. 604, 604-05 (1985) (explaining the behavior of litigants as it pertains to cultural characteristics); Ramseyer, *Legal Rules in Repeated Deals: Banking in the Shadow of Cheats in Japan*, (forthcoming J. LEGAL STUD. (Jan. 1991)) (discussing the system of “main banks” in Japan, and Japanese banks’ treatment of troubled borrowers); Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. REV. 1, 4-6 (1987)

There may be no authoritative way to resolve this debate, since what is important in terms of cultural differences lies largely in the eye of the beholder. Yet it is also possible that detailed investigation of a specific subject area might yield at least some insights into the question.

The present study is such a detailed investigation of a particularly intriguing—and economically significant—parallel development in Japan and the United States. In 1987, regulators in both Japan and the United States allowed commercial banks to enter the business of underwriting commercial paper (short-term, unsecured corporate promissory notes).

That this important development occurred in both countries at roughly the same time suggests support for the arguments of the continuity theorists. They believe that the Japanese and American systems are quite similar in their actual functioning, despite apparent cultural differences.

At the same time, however, the similarity in the actions taken by the two governments is matched by an equally striking dissimilarity in the methods by which those actions were brought about. In the United States, bank entry into the commercial paper market was initiated by a private institution, Bankers Trust New York Corporation. Federal regulators did not design or implement the marketplace changes and were largely cast in the role of reacting to changes that were already occurring. Some of the major government decisions allowing the market to go forward, moreover, were made by courts of law rather than the regulatory administrative agencies.

In Japan, by way of contrast, the development of a commercial paper market with bank involvement was carefully controlled at every step by a government agency, the Ministry of Finance (MOF). No private entity took the initiative to move the process forward by entering the commercial paper business without prior MOF approval. Moreover, in Japan, litigation was not only absent, but was never seriously considered as a step towards resolution of the

(discussing the phenomenon of takeovers in Japan and considering these implications as they pertain to the American experience); Ramseyer, *Water Law in Imperial Japan: Public Goods, Private Claims, and Legal Convergence*, 18 J. LEGAL STUD. 51, 53 (1989) (discussing the “similarities between [the Japanese] legal regime and the prior-appropriation regime in the American West”). Although the theory set forth in the present study differs in some respects from Ramseyer’s general views on the subject, the authors are greatly in his debt for defining the debate and for many insightful observations.

controversy. The views of those interests affected were made known to the government through an elaborate series of *ex parte* contacts at all levels of seniority. This is something that would have been unthinkable, and probably illegal, at many stages of the proceedings in the United States.³ These differences in method lend some support to proponents of the difference hypothesis, who would suggest that, despite the apparent similarity of result, the whole process was radically different due to cultural influences.

Our view, based on an examination of this one limited, albeit important, development in the commercial life of Japan and the United States, is that neither the similarity nor the difference hypothesis fully explains the evidence under review. In both countries the question of bank involvement in commercial paper distribution was a fundamental bone of contention between two powerful industries, banks and securities firms, because commercial paper represents a deep threat to the core banking business of providing short term credit to business enterprises. In each case, the political battle over commercial paper was fought by powerful and well-organized special interest groups, and resolved in part by bureaucratic agencies anxious to preserve their regulatory "turf."⁴ Although to a casual observer the Japanese events may have appeared more cordial and less nakedly self-interested than the American experience, they actually involved an interest-group battle of ferocious intensity raging within the relatively private confines of the MOF. The nature of the events in Japan was revealed to us

³ The Administrative Procedure Act, 5 U.S.C. §§ 551-559, 701-706 (1988), prohibits communications between any "member of the body comprising the agency, administrative law judge, or other employee who is or may reasonably be involved" and anyone involved in the decision-making process or an interested party outside the agency, if such communications are relevant to the merits of the proceeding. *Id.* § 557(d).

⁴ A recent and perhaps notorious example of this sort of behavior in the United States took place when officials of the Securities and Exchange Commission sought to divest the Commodities and Futures Trading Commission of its jurisdiction over the regulation of stock-index futures. *See, e.g., Egan, Coping with Stock-Market Tremors*, U.S. NEWS & WORLD REP., Aug. 13, 1990, at 66 (noting that "[e]fforts by Treasury Secretary Nicholas Brady to give the Securities and Exchange Commission authority to regulate stock-index futures as well as stocks have bogged down in a jurisdictional wrangle between the SEC and the Commodity Futures Trading Commission, the current overlord"); Hinden, *Brady Loses in Fight for Futures Bill; Senate Panels Scuttle Provision on Control*, Wash. Post, July 28, 1990, at D10, col. 6 (noting that Treasury Secretary Nicholas Brady had "lobbied hard for passage" of legislation that would have reassigned jurisdiction over the regulation of stock-index futures from the CFTC to the SEC but had faced "the implacable opposition of the CFTC, the Chicago futures market and members of Congress with close ties to the agricultural industry").

through our research which included interviews with many of the key participants in both government and the private sector and which focused on the actual mechanics of the Japanese decision.⁵ There is no evidence that the Japanese motives were any more noble or less self-interested than those of the American participants.

At the same time, there are undeniable and important differences between the Japanese and American approaches to the conflict. In part, we find that these differences stem from variations in institutional structure. Because the Japanese MOF has overarching responsibility for both securities firms and banks, the conflict between these industries was channeled inside the walls of that agency rather than spilling out into the public arena. The latter was the case in the United States where banks, but not securities firms, are represented and influential within the relevant agency (the Federal Reserve Board⁶).

In part, the differences also appear to reflect the influence of factors that could be labeled "cultural." Japanese society—at least the Japanese commercial society that we studied—is marked by the extensive use of "preclearance":⁷ conflicts are addressed and resolved in a variety of settings by informal and private means before any party is forced to take a public stand on an issue. It is this feature of preclearance that generates the popular cliché of

⁵ In researching this Article, we conducted detailed discussions with over 30 individuals in Japan, including high-ranking officials at the Ministry of Finance, the Ministry of International Trade and Industry, and the Bank of Japan, important professors from law faculties, including the University of Tokyo, officials from leading securities houses and banks, and representatives of the Japan Securities Research Institute and the Japan Bankers Association. We found all our informants to be both knowledgeable and extraordinarily forthcoming about the inner workings of the decision process in Japan. We also interviewed leading securities traders and bank officials in the United States.

The present study is outside the tradition of American law review articles in that it is based largely on the results of detailed interviews with actual participants in the process. Our goal has been to look behind the formal documentation of decisions to determine more precisely the actual forces which shaped the outcome. In addition, as we discuss below, *see infra* text accompanying note 10, our focus is not simply on the development of legal doctrine, but rather on the complex and subtle interplay among four great social systems: politics, markets, technology, and law. We believe that our interviewing technique is a useful supplement to the written record as a means for bringing into clearer focus the influence of each of these four systems and the complex interplay among them.

⁶ We use the term "Federal Reserve Board" interchangeably with other popular locutions, including Federal Reserve and the Fed.

⁷ For a fuller discussion on the "preclearance-postclearance" distinction, see *infra* text accompanying notes 205-27.

Japanese society as based on "consensus." The appearance of consensus does not indicate any lack of conflict within Japanese society; rather, it reflects the fact that conflicts are typically addressed and resolved in advance of any overt public confrontation. In contrast, decisions in the United States are often reached by "postclearance" mechanisms, in which parties are free—indeed, encouraged—to take public stands that generate confrontation for the relevant decision-maker's formal, on-the-record resolution. The history of the commercial paper struggle in the two countries amply illustrates the difference between preclearance and postclearance methods of dispute resolution.

It is not at all evident that one method is better than another in any a priori sense. A naive view might see the Japanese system as intrinsically better because fewer social resources are devoted to conflict resolution. This view is notoriously present in Derek Bok's famous jeremiad on the American legal profession,⁸ which he portrays as draining the best talent away from more fruitful occupations such as business, medicine, or education. Bok suggests that the United States would benefit by becoming more like the Japanese, with their minuscule lawyer-to-population ratio and mighty productive capacities. Yet, aside from the factual shortcomings in Bok's critique,⁹ it is grossly shortsighted because it fails to recognize the presence in Japan of a pervasive, and extremely resource-intensive, system of dispute resolution through preclearance.

An approach more sophisticated than Bok's might attempt to determine whether the Japanese preference for preclearance and the American preference for postclearance represent intrinsic differences between the two cultures, or simply different choices by the relevant decision-makers. By studying one set of analogous decisions in the two nations, we can gain insight into the relationship between behavior and culture in the United States and Japan.

In examining the developments in Japan and the United States, we consider the interplay of four factors: politics, markets,

⁸ See Bok, *A Flawed System of Law Practice and Training*, 33 J. LEGAL EDUC. 570 (1983).

⁹ For example, Bok fails to observe that although the ratio of *bengoshi* (people who have passed the bar) to population is much lower than the American lawyer-to-population ratio, the ratio of law school graduates to population in Japan is much higher than in the United States. Many of these law graduates go on to careers that in the United States would require a license to practice law. See Tsubota, *Myth and Truth on Non-Litigiousness in Japan*, 30 U. CHI. L. SCH. REC. 8, 9 (1984).

technology, and law. Rather than viewing the law relating to commercial paper in isolation from the other three, we see that each factor profoundly shapes the law. As we demonstrate below, the evolution of the law in the commercial paper area had an important political dimension; indeed, in both the United States and Japan, the legal developments were largely, although not wholly, driven by the influence of powerful political interest groups. Technology also influenced the events recounted here: as world markets have become linked through modern computer and communications facilities, markets in both the United States and Japan have increasingly been able to "securitize" assets.¹⁰ The role of the financial intermediary has accordingly become less crucial to developed economic systems over the past decade than it was previously. And market developments such as the growth of money market mutual funds, the increasing globalization of financial markets, and the dramatic weakness shown in parts of the American banking and securities industries over the past few years have all contributed to the unfolding of the events recounted in this study.

At the same time, we do not view the legal environment simply as a passive product of these other systemic developments. Although changes in the law may be influenced or even caused by developments in politics, markets, and technology, legal changes also influence the other systems by altering political alignments, restructuring markets, and stimulating the development of new technologies. Thus, the relationships of all four systems are deeply reciprocal. Economic history is the result of the dynamic interplay among them.

This politics-markets-technology-law perspective on economic history is inherently complex in structure. No one variable can be identified to "explain" any particular development, although lines of proximate causality often can be traced with some degree of confidence. All developments depend on the influence of a variety of different variables, operating within an overall system that is moving constantly towards equilibrium but, at the same time, is disturbed repeatedly by new and often unexpected developments. Thus, the discussion that follows does not identify any single factor that uniquely explains the developments in Japan or in the United States. It does identify, at least tentatively, the concatenation of

¹⁰ See generally Comment, *Collateralized Mortgage Obligations: Probing the Limits of National Bank Powers Under the Glass-Steagall Act*, 36 CATH. U.L. REV. 1025 (1987) (discussing legal limitations on national banks to securitize mortgage assets).

causes that together influenced these developments, and it offers some thoughts as to why these particular constellations of forces may have arisen, and why the mix of factors differed between Japan and the United States.

This Article is structured as follows. Part I provides a brief introduction to commercial paper, and to the structure of the American and Japanese financial services industries. Part II examines the American experience with bank entry into the commercial paper market. Part III treats the parallel Japanese experience. Finally, Part IV ties the two histories together and draws conclusions about their similarities and differences.

I. BACKGROUND

Commercial paper is one of the various devices which corporations use to raise funds. It is a short-term, unsecured obligation of the corporation, issued for a fixed amount and bearing a fixed rate of interest. Commercial paper occupies a middle ground between stocks and bonds, on the one hand, and commercial loans on the other; it is sold in a market like stocks and bonds, rather than being individually negotiated like commercial loans, but the sales generally occur by private placement, rather than through public offerings.

For the issuers, commercial paper is an attractive financing vehicle because it provides ready access to capital markets without requiring extensive negotiations or creating long-term obligations. For investors, it is attractive because it pays higher interest than most bonds or treasury bills, and yet is relatively safe; while the paper is not backed by any specified assets, its short-term character means that any major issuer is unlikely to decline to the point of insolvency during the brief period before the paper matures. In addition, commercial paper may be backed by a letter of credit from a bank or other financial institution.

From this description, one might assume that the amount of commercial paper that a corporation issues, relative to other financing instruments, is a matter of interest primarily to students of economics or business administration. In certain European countries, such as West Germany, where there are virtually no restrictions on a bank's range of activities, this is in fact the case. In the United States and Japan, however, commercial paper has become a major political, regulatory, and legal issue because of the separation of financial institutions into banks and securities firms. In both nations, deposit-taking institutions—that is, banks—have

been allowed to make commercial loans but have been prohibited from underwriting securities. This excludes banks from being the primary manager, or underwriter, of corporate securities issues, since the underwriter's role is typically to buy the entire issue and take the risk that some of it cannot be sold at the original price. Instead, underwriting is performed by investment banks, which are actually securities firms that buy and sell for their own accounts and engage in various other transactions. To maintain the separation of commercial banks and investment banks, the investment banks are prohibited from accepting deposits.¹¹

In recent years, there has been a collision between the legal regime separating commercial banks from securities firms and the intermediate character of commercial paper.¹² Because commercial paper can readily substitute for commercial loans, banks want to participate in marketing it. Only the larger, more stable, corporate borrowers can issue commercial paper, but those are naturally the customers that banks are most anxious to retain. Because commercial paper can substitute for corporate securities, however, the securities firms (investment banks) would like to keep the banks out of the market. To them, bank participation in commercial paper transactions represents an incursion into a field that previously has been their exclusive and highly profitable preserve.

¹¹ The prohibition on deposit-taking by investment banks is contained in § 21 of the Glass-Steagall Act, 12 U.S.C. § 378 (1988). For a comprehensive discussion of the Glass-Steagall Act and its implications for commercial banks and securities firms, see H. PITT, J. WILLIAMS, D. MILES & A. AIN, *THE EVOLVING FINANCIAL SERVICES INDUSTRY* (1985).

¹² See, e.g., Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 4 (1984) (noting that "the commercial paper market is in direct competition with commercial bank loan departments as a source of credit to top industrial borrowers"); Comment, *Securities Activities Under the Glass-Steagall Act*, 35 EMORY L.J. 463, 463 (1986) (discussing recent conflicts arising between commercial banks and securities firms).

Most recently, the Federal Reserve Board authorized a commercial bank, J.P. Morgan, to underwrite equity securities. See Duke & Smith, *Fed Allows J.P. Morgan to Underwrite Stocks*, Wall St. J., Sept. 21, 1990, at C1, col. 3. The Fed's favorable response to the Morgan application represented the first time a bank has been empowered to engage in such underwriting since 1933. See *id.* The Fed's move generated controversy in the investment community. See, e.g., Power & Salwen, *Winners, Losers Take Stock of Glass-Steagall Battle: Securities Industry Has Little Leverage*, Wall St. J., Sept. 24, 1990, at C1, col. 3 (noting effort by securities industry to maintain a competitive advantage in light of the decision of the Federal Reserve); Sease, *Winners, Losers Take Stock of Glass-Steagall Battle: Banks Bask in Equity-Underwriting Victory, but New Role May Prove Symbolic for Now*, Wall St. J., Sept. 24, 1990, at C1, col. 5 (noting that while the Fed decision is of strategic importance to banks, it may not represent an immediate threat to the securities industry).

The conflict between banks and securities firms in the United States and Japan emerged from a similar legal background, but developed differently because of dissimilarities in the economic and regulatory regimes in the two countries. In the United States, the existence of commercial paper preceded the separation of banking and securities firms. There has been a commercial paper market in America since the end of the eighteenth century.¹³ It evolved from the use of bearer promissory notes as short-term financing vehicles; the merchant would write the note, and a dealer would arrange its sale at a discount to a third party or, more rarely, purchase the note with an intent to resell it at a higher price. The incentive for relying on this mechanism was the endemic credit shortage in many parts of the country, particularly in the South and the West. Since American banks were limited to operating in one state at the most, and often to one city or one branch, credit did not flow readily from one part of the country to another. The sale of commercial paper was a relatively effective means of establishing a nation-wide credit market.

The early dealers in commercial paper tended to be private money brokers or merchant houses who would bring the buyer and the issuer together for a suitable commission. In the late nineteenth century, some of the dealers began to purchase the paper for their own accounts. A few banks dealt in commercial paper as well, either as brokers or, more frequently, by purchasing the paper and then reselling it to other banks with which they had correspondent relationships. For the most part, however, banks were in the commercial paper market as buyers rather than dealers.

These practices and, indeed, the entire structure of the American financial services industry, were transformed by the legislation following the financial crisis of the Great Depression. In 1933, the Glass-Steagall Act¹⁴ effected the separation of banking and securities dealing, although it is unclear whether the motivation for passage of this Act was concern about commercial bank insolvency or the lobbying efforts of the investment banks.¹⁵

¹³ For the history of the United States commercial paper market, see generally, N. BAXTER, *THE COMMERCIAL PAPER MARKET* (2d ed. 1966); A. GREEF, *THE COMMERCIAL PAPER HOUSE IN THE UNITED STATES* (1938); Hurley, *The Commercial Paper Market*, 63 Fed. Res. Bull. 525 (1977).

¹⁴ 12 U.S.C. § 24, paras. 7, 78, 377-78 (1988).

¹⁵ See Macey, *supra* note 12, at 15-21 (arguing that the Glass-Steagall Act was enacted as the result of interest-group pressures). *But see* Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking*

Section 16 of the Act limits a commercial bank to buying and selling securities "without recourse, solely upon the order, and for the account of, customers, and in no case for its own account . . ."¹⁶

Section 21 forbids firms which buy and sell for their own account, or which underwrite securities, from engaging "to any extent whatever in the business of receiving deposits . . ."¹⁷ Technically, the Glass-Steagall Act applies only to banks that are members of the Federal Reserve System, and the wording of its provisions is far from being air-tight. Nonetheless, the Act was long regarded as barring commercial banks from dealing in commercial paper, whether by acting as brokers (placing the paper with buyers) or as underwriters (purchasing for their own account with an intent to resell). This view was so well accepted that banks did not attempt to deal in commercial paper for nearly fifty years.

The banks' hands-off attitude towards commercial paper undoubtedly reflected the stability and profitability of commercial banking during the post-Depression period. With a rapidly-expanding economy generating increasing demands for commercial loans, banks had little economic incentive to enter the commercial paper market. That market, moreover, had declined precipitously even before the Depression; between 1920 and 1933 the amount of commercial paper outstanding fell from one billion to one hundred and thirty-nine million dollars.¹⁸ Many dealers left the market or merged, with the result that market concentration increased rapidly. By 1938, nine major dealers controlled ninety percent of the market. These conditions continued through the 1960s, and kept the commercial paper market from seeming like either a threat or an opportunity to commercial banks.¹⁹

In the late 1960s, however, large corporations began to rely increasingly on commercial paper to fund their short term financing needs. The spreads and placement costs on commercial paper fell low enough that a corporation could often save money by going directly into the commercial paper market rather than by obtaining funds from a bank or another financial intermediary.²⁰ In addi-

Regulation, 85 MICH. L. REV. 672, 716-17 (1987) (arguing that the Glass-Steagall Act was intended "as much as anything . . . to redirect the resources and energies of the banking industry back to the historic role as provider of commercial credit").

¹⁶ 12 U.S.C. § 24, para. 7 (1988).

¹⁷ *Id.* § 378(a)(1).

¹⁸ See Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, 362 n.2 (1972) (citing N. BAXTER, *supra* note 13, at 17).

¹⁹ See *id.* at 365-66.

²⁰ From 1964 to June 1971, the savings differential on commercial paper as

tion, many corporations relying on bank loans for financing were effectively forced to issue commercial paper in 1966 when bank credit temporarily dried up as a result of high nominal interest rates.²¹ Once having entered the commercial paper market, many firms were reluctant to return to higher-cost bank financing even when bank funds became readily available again.²² Commercial paper outstanding grew fivefold, from \$10.1 billion in 1966 to \$52.6 billion in 1976.²³ Banks, to their surprise and dismay, began to see commercial paper as a threatening competitor for their core loan business.²⁴

The problem was not simply a loss of loan revenues, although this was bad enough. In addition, commercial banks were deprived of key information about the activities of their loan customers. In the days when corporations returned to their banks frequently to roll over commercial loans, banks were able to maintain regular contact with their customers and thus to obtain reliable, current information about them. That source of information began to dry up as blue chip corporations increasingly turned to the commercial paper market for their short-term financing needs. Faced with these circumstances, banks began to reevaluate the long-accepted notion that the Glass-Steagall Act prohibited them from dealing in commercial paper.

In Japan, the separation of banking and securities firms preceded the development of commercial paper as a mechanism for corporate finance. The separation was effected by article 65 of the Securities and Exchange Law of 1948 (SEL)²⁵ which was imposed on Japan during the American occupation. SEL prohibits banks, inter alia, from underwriting securities, engaging in the public offering of outstanding securities, and handling the public offering of new or outstanding securities.²⁶ This law represented a departure from the pre-war organization of the Japanese financial services industry. Following the Meiji Restoration of 1868,²⁷ Japan had

compared with the bank prime rate was approximately .93%. *See id.* at 365 n.10.

²¹ *See* Hurley, *supra* note 13, at 531-32.

²² *See id.* at 532.

²³ *See id.* at 525.

²⁴ *See id.* at 525 (noting that "[f]or the firms that issue it, commercial paper is an important substitute for bank credit"); Interview with Thomas A. Parisi, Senior Vice President, Bankers Trust Company (Apr. 11, 1989) [hereinafter Parisi interview].

²⁵ Law No. 25 of 1948.

²⁶ *See id.* at art. 65, para. 1.

²⁷ The Meiji Restoration, along with infusion of Chinese culture and the establishment of the Shogunate, was one of the great turning points in Japanese history. The

developed a universal banking system organized along European lines. Securities underwriting was dominated by government banks, such as the Industrial Bank of Japan, and banks that were members of the great industrial groups, or *zaibatsu*, such as Mitsui Bank. Securities firms existed, but acted only as brokers and distributors of issues to the general public. The imposition of article 65 was a product of the interesting American belief that a democratic regime not only required free elections, free speech, and due process, but also antitrust laws and the Glass-Steagall Act.²⁸

From the Japanese perspective, article 65 "fulfills no domestic policy purpose and exists only by virtue of historical accident."²⁹ As one might expect, engrafting this provision upon an already well-developed financial services industry led to different results from those that its original produced in the United States. Most notably, the old *zaibatsu* have managed to knit together business alliances, called *keiretsu*, and retain many of their pre-war relationships on an informal basis. These relationships are cemented by a practice of cross-shareholding, where each member company owns up to 5% of the equity in the other companies. Banks participate in this practice, just as they participated in the erstwhile *zaibatsu* system. Cross-shareholding is permissible under article 65 which states that banks may purchase securities for their "own investment purpose[s]."³⁰ While the United States Comptroller of the Currency construed the analogous Glass-Steagall language to permit only the purchase of marketable debt instruments, not stock, article 65 has been construed as permitting stock purchases. Moreover, Japanese banks, unlike American banks, are not forbidden from affiliating with securities firms. Thus, a securities firm can become a member of a *keiretsu* that includes a bank. All of the major Japanese banks

Meiji Restoration marked the downfall of the Shogun and the beginning of a modern state in Japan, under the guise of restoring the Emperor to his throne. For a general discussion, see, e.g., J.W. HALL, *JAPAN FROM PREHISTORY TO MODERN TIMES* 265-72 (1970) (discussing political and cultural effects of the Meiji Restoration); P. TASKER, *supra* note 1, at 20-23 (describing Western influence on Japan during the Meiji Restoration); and M. YOSHINO, *JAPAN'S MULTINATIONAL ENTERPRISES* 3-6 (1976) (explaining the causes and describing the effects of the Meiji Restoration).

²⁸ For a discussion of American sponsored reforms in the Japanese financial sector, see F. ROSENBLUTH, *FINANCIAL POLITICS IN CONTEMPORARY JAPAN* 39-41 (1989). For a general discussion of legal reforms effected during the American occupation of Japan, see E. REISCHAUER, *supra* note 1, at 105-09.

²⁹ Dale, *Japan's "Glass-Steagall Act,"* 2 J. INT'L BANKING L. 138-41 (1987).

³⁰ Law No. 25 of 1948.

have become informally affiliated with one or more securities firms.³¹

As a matter of practice, it appears that Japanese banks can in fact participate in underwriting Japanese corporate debt despite the SEL's specific prohibitions. They do so by acting as "commissioned underwriting companies," which means they serve as advisor, agent, and trustee for the issuing corporation. Banks also assume the default risk in case the issuing company becomes insolvent. This practice is done not as a legal obligation, since article 65, like the Glass-Steagall Act, forbids doing so, but as a moral one, legally unenforceable but well-recognized and well-accepted.³² American banks do not assume such moral obligations. Even if they were to declare that they would assume such obligations, securities buyers would not believe them. The inability of United States banks to declare *ex ante* that they will guarantee corporate debt means that they cannot compete with investment banks that are permitted to engage in firm commitment underwriting. Since Japanese banks can credibly commit themselves to assume the risks of the debt securities they place, they are able to play a significant role in underwriting corporate debt.

Despite these differences and the more lenient interpretation Japanese authorities have given their imported article 65, this provision is not without effect in Japan. The separation of the banking and securities businesses has led to the evolution of independent securities firms with their own corporate identity, markets to defend, and network of political influence. The four largest firms have evolved into powerful financial institutions. One of these, Nomura Securities, can reasonably be regarded as the most formidable (and profitable) company in the Japanese financial services industry.³³ Thus, when the conflict over commercial paper arose, Japanese banks, despite the porous nature of article 65 restrictions, found themselves facing a worthy set of adversaries.

³¹ See Dale, *supra* note 29, at 139 (noting the commonality of the practice); *A Survey of Japanese Finance*, ECONOMIST, Dec. 10, 1988, at 13-14.

³² See Nagao, *The Bond Market*, reprinted in E. SAKAKIBARA & Y. NAGAO, *STUDY ON THE TOKYO CAPITAL MARKETS* 63-64 (1985) (remarking that "in the case of an actual default . . . it is the commissioned bank which has protected the investor by purchasing such outstanding bonds at par value").

³³ See, e.g., A. ALLETZHAUSER, *THE HOUSE OF NOMURA* xi (1990) (stating that "Nomura has more assets under custody than . . . the world's largest bank; makes more money than any financial firm in the world; controls 20% of the Japanese bond market; and dominates the Eurobond underwriting tables").

This conflict did not emerge until the late 1970s for the simple reason that there was no commercial paper in Japan. The only short-term financial markets in existence prior to that time were the call market, the bill discount market established by the Bank of Japan in 1971 in which financial institutions trade discounted promissory notes issued by corporations, and the *gensaki* market, a market for bonds with repurchase agreements that gained prominence and official recognition in the 1970s. The call market is limited to financial intermediaries, while the bill discount market is further restricted to commercial banks and money brokers. Moreover, until very recently, the market for short-term Japanese government debt has been insignificant.³⁴

Only the *gensaki* market was open to sizeable investment by non-financial corporations. As a market for bonds with repurchase agreements, however, it does not provide most corporations with a method for borrowing short-term funds. Only a corporation that holds a large portfolio of long-term bonds can raise short-term funds by *gensaki* transactions, selling bonds with repurchase agreements. Because of the lack of a commercial paper or similar market, Japanese industry essentially lacked any alternative to short-term financing from banks.

Bank borrowing was, and to a lesser extent continues to be, the dominant method of raising both short and long-term capital for industry. Banking itself is divided into several distinct markets. Commercial banks are restricted to the market for deposits of three years or less duration. Smaller commercial banks, the regional and mutual banks, generally have a net excess of funds deposited through extensive branch networks. They supply some of these excess funds to the twelve large commercial banks called the City Banks. The City Banks dominate short-term finance to large corporations by serving as the "main banks" of these corporations. Several City Banks form the nuclei of the *keiretsu*. They tended to be "overloaned" throughout the high-growth era, borrowing from the smaller banks through the interbank call and bill discount markets and from the Bank of Japan's discount window.³⁵

³⁴ See *Opening the Door to Japan's Short-Term Money Markets*, ECONOMIST, Apr. 1, 1989, at 65 (noting that Japan's treasury bill market is only one twenty-fourth the size of the United States' treasury bill market).

³⁵ See Wallich & Wallich, *Banking and Finance*, in *ASIA'S NEW GIANT: HOW THE JAPANESE ECONOMY WORKS* 249, 284-90 (H. Patrick & H. Rosovsky eds. 1976); see also Y. SUZUKI, *MONEY AND BANKING IN CONTEMPORARY JAPAN* 3-13 (1980) (explaining the concept of "overloan" and noting that in the early 1970s Japan was the only major

The seven trust banks and three long-term credit banks are restricted to the longer-term market segments. Both groups are permitted to raise medium- and long-term funds in order to provide longer-term capital for industrial development.

While deregulation has begun to blur distinctions between trust banks, long-term credit banks, and commercial banks, the City Banks still dominate short-term finance for large Japanese corporations. Smaller commercial banks, trust banks, and long-term credit banks therefore did not have much direct interest in the commercial paper debate. In the controversy described below, the City Banks did most of the lobbying and negotiating.

II. THE AMERICAN EXPERIENCE

A. *The Bankers Trust Initiative in Placing Commercial Paper*

In 1978, Bankers Trust Company, a state-chartered member bank of the Federal Reserve System, challenged the prevailing view that the Glass-Steagall Act barred banks from any substantial role in the distribution of commercial paper. Bankers Trust did so by acting as agent for several large corporate customers that wanted to place commercial paper with investors.³⁶ The company's decision to enter the market was apparently defensive: Bankers Trust was not seeking to poach on the turf of securities firms, but rather to protect its core loan business and customer relations against competition from securities firms.³⁷

It is not clear why Bankers Trust adopted a "go it alone" strategy. To be sure, as a major city bank serving the credit needs of large corporations, Bankers Trust had much to lose from commercial paper competition. But so did other big banks, such as Citibank, Chase Manhattan, and Manufacturers Hanover. There were significant free rider effects in this situation. By acting unilaterally, Bankers Trust benefitted not only itself, but also its rival banks which stood to profit from a ruling allowing bank involvement in the commercial paper market. Furthermore, it

country in which the central bank was a net lender).

³⁶ Banks previously had purchased commercial paper for their own accounts and had acted for customers in purchasing paper, but had not represented issuers in distributing it. See Policy Statement Concerning the Sale of Third Party Commercial Paper by State Member Banks, 46 Fed. Reg. 29,333, 29,334 n.4 (1981).

³⁷ See Horowitz, *Bankers Trust Moves Ahead in Commercial Paper, Suit by Suit*, AM. BANKER, Sept. 23, 1987, at 16, 24.

might well have been cheaper and safer for Bankers Trust to seek prior Federal Reserve Board approval for its commercial paper activities. Bankers Trust would probably have received the support of other big commercial banks in any proceeding before the Federal Reserve, or before the courts on petition for review of the Board's decision.

Bankers Trust's decision to follow the arguably riskier course of unilateral action was apparently designed to gain a number of advantages. First, the decision-makers at Bankers Trust no doubt understood that a dealer must work in volume to survive in the commercial paper business.³⁸ Accordingly, Bankers Trust may have hoped to get a jump on other commercial banks as a dealer in commercial paper. If so, its strategy succeeded: even today it is the leading bank in the market, although its market share falls short of the leading securities firms.³⁹ Second, Bankers Trust believed that gaining a toehold in the market, while not necessarily profitable in itself, would allow it to establish lines of communication with corporate customers that would place it in an advantageous position for selling other, more profitable, bank services.⁴⁰ Third, Bankers Trust had decided in 1978 to focus on wholesale as opposed to retail banking, and to develop an in-house investment banking capability.⁴¹ Entry into the commercial paper market was an important step in this direction. Finally, Bankers Trust may have

³⁸ As of December 1988, Bankers Trust handled approximately \$11 billion in commercial paper outstanding (i.e., unmatured paper placed by a company at any given time), representing less than 5% of the market. Although it was the sixth largest player in the market, as measured by the amount outstanding, its market share was far below those of the four leading securities firms: Merrill Lynch (\$70 billion outstanding), Goldman Sachs (\$60 billion), Shearson Lehman Hutton (\$55 billion) and First Boston Corp. (\$30 billion). See Neustadt, *Big Banks Make Gains Placing Corporate Paper*, AM. BANKER, Dec. 6, 1988, at 1, 14.

It is not at all clear that even with programs totaling \$11 billion Bankers Trust was able to make a profit. Trading professionals we interviewed believe that the break even point for commercial paper placement is approximately \$25-30 billion, as evidenced by the fact that Salomon Brothers dropped out of the commercial paper market with approximately \$28 billion of commercial paper outstanding. See Interview with Richard Fuscone & T. James Smithwick of Merrill Lynch Money Markets Inc. (Apr. 11, 1989) [hereinafter Fuscone & Smithwick interview].

³⁹ See Neustadt, *supra* note 38, at 14.

⁴⁰ See Parisi interview, *supra* note 24.

⁴¹ See *id.* Traders we interviewed at other firms indicated that Bankers Trust was known in the market as having a "good trading desk" and a "trading mentality or mindset," stemming partly from the influence of its Chairman, who was widely known as an innovative force within the banking industry.

intended to establish a reputation as a dynamic innovator in the financial services industry.⁴²

In all likelihood, Bankers Trust consulted informally with Federal Reserve Board officials before actually entering the commercial paper market.⁴³ No law prevented this type of informal consultation, and the bank could only gain from it, given the virtual certainty of a legal challenge from the securities industry which would draw the Board into the decision sooner or later. We do not know whether or not Bankers Trust received any informal assurances from Board officials. We are confident, however, that Bankers Trust would not have proceeded unilaterally if it suspected that the Board would disapprove, given the Board's enormous discretionary powers over banking institutions and its reputation for punishing banks which provoke it.⁴⁴

The securities industry quickly sought to quash the Bankers Trust commercial paper program. The Securities Industry Association (SIA), a national trade association of securities firms, approached the Board on an informal basis to complain of the activity.⁴⁵ When the Board declined to act, the SIA—acting on

⁴² A Bankers Trust officer we interviewed denied this motivation, however. *See id.*

⁴³ *See id.* We learned that the legal department of Bankers Trust engaged in extensive communications with the regulators, and probably advised them of the planned entry into commercial paper. It should be noted that these informal consultations represent a form of "preclearance" which, as we argue throughout this paper, is more characteristic of Japanese than American decision-making. However, Bankers Trust knew that the Board was its ally on this issue; thus the prior consultation was not a form of conflict resolution of the sort that occurs so widely in Japan. Moreover, our argument is not that preclearance is absent in the United States—or postclearance in Japan—but rather that the United States and Japan differ dramatically in the degree to which the two methods are used.

⁴⁴ A revealing glimpse into the powers of the Board is provided in a story well-known in the banking community. The episode involved the Board's treatment of New Jersey's Horizon Bank in 1985 after that institution had won approval from the Comptroller of the Currency to relocate a branch across state lines. Interstate branching of any sort threatens the Board's regulatory jurisdiction, which operates principally at the holding company level. *See, e.g., Miller, Interstate Branching and the Constitution*, 41 *BUS. LAW.* 337, 338 (1986) (examining "the constitutionality of state laws that prohibit entry by branches of out-of-state banks"). The Board reportedly responded to Horizon's action by threatening to refuse check-clearing services to the bank, a move which would have devastated the bank's operations. Not surprisingly, Horizon dropped the idea of an interstate branch. *See Rehm, Bradfield Bids Reluctant Adieu to the Fed*, *AM. BANKER*, Feb. 21, 1989, at 1. Although the Board official involved in that matter has departed from the scene, the object lesson about the Board's powers remains cogent.

⁴⁵ *See Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys.*, 468 U.S.

behalf of the securities industry—formally petitioned for a ruling that the Bankers Trust activities violated sections 16 and 21 of the Glass-Steagall Act.⁴⁶ The Board denied the petition in 1980.⁴⁷ Applying a functional analysis, the Board determined that commercial paper was not a “security” subject to the Act since its economic role is more akin to a standard commercial bank loan than to a corporate security. The Board did recognize, however, that the Bankers Trust activities posed potential hazards, and accordingly issued a “policy statement” restricting the terms under which member banks could enter the market.⁴⁸

The consequence of the Board’s decisions was to create a system of administrative control virtually unfettered by statutory standards. By first declaring that commercial paper is not a security and then imposing a relatively elaborate set of discretionary administrative constraints on bank involvement in commercial paper sales, the Board maximized its own administrative control of the situation and retained the flexibility to ease those constraints as the market evolved. In contrast, if the Board had declared commercial paper to be a “security” it would have had no choice but to invalidate

137, 140 (1984) [hereinafter *Bankers Trust I*].

⁴⁶ Section 16 of the Act provides, in relevant part, that

[t]he business of dealing in securities and stock by [a commercial bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock.

12 U.S.C. § 24, para. 7 (1988). Section 21(a)(1) makes it unlawful for any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor.

Id. § 378(a)(1).

⁴⁷ See *Bankers Trust I*, 468 U.S. at 141.

⁴⁸ The most important restrictions were the following: member banks were limited to selling “prime quality” paper to “financially sophisticated” investors; they were not permitted to advertise to the general public; they could not sell paper with denominations below \$100,000; they were required to use due diligence in investigating the financial affairs of the issuer; and they were prohibited from selling commercial paper to fiduciary accounts over which they exercised investment discretion. See Policy Statement Concerning the Sale of Third Party Commercial Paper by State Member Banks, 46 Fed. Reg. 29,333, 29,334-35 (1981).

actions by member banks which constituted underwriting of commercial paper.

The SIA petitioned for review of the Board's order declaring commercial paper to be outside the scope of the term "security" in the Glass-Steagall Act. The case eventually reached the Supreme Court, which in 1984 reversed the Board and held commercial paper to be a "security" for purposes of the Act.⁴⁹ The Board's interpretation was flawed, according to the Court, because excluding commercial paper from the definition of a security under the Glass-Steagall Act would threaten some of the "subtle hazards" which, in the Court's view, Congress had feared when it enacted the statute. For example, the Court suggested that a bank's "salesman's interest" in a commercial paper issue might lead it to enhance the marketability of the paper by extending backup credit to the issuer.⁵⁰ In addition, the bank might purchase unsold paper which it was distributing, in order to establish its reputation as a reliable dealer, even if the paper did not meet ordinary credit standards,⁵¹ or market commercial paper issues to its depositors, with the attendant danger of loss of confidence in the bank if the issuer were to default.⁵² Finally, a bank's interest might cause it to slant its investment advice to depositors, especially if the proceeds of the commercial paper issuance were to go towards retiring an existing loan with the bank.⁵³

The Supreme Court's decision was unusual in that the Court refused to defer to the views of an expert administrative agency on a subject within the agency's administrative competence.⁵⁴ It is probable that the Justices in the majority saw two chief problems with the Board's actions that warranted a departure from the usual rule of deference.

First, the Board had admitted that bank sales of commercial paper posed hazards. This was the basis for its order limiting the

⁴⁹ See *Bankers Trust I*, 468 U.S. 137 (1984).

⁵⁰ See *id.* at 155.

⁵¹ See *id.*

⁵² See *id.* at 155-56.

⁵³ See *id.* at 156.

⁵⁴ The Court's failure to defer to the Board's interpretation was the basis for Justice O'Connor's lengthy dissent, joined by Justices Brennan and Stevens. See *Bankers Trust I*, 468 U.S. 137, 160-82 (1984); cf. *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984) (stating that deference should be given to an executive department's construction of a statutory scheme it administers, and applying this deference to the Environmental Protection Agency's definition of a term in the Clean Air Act).

terms on which such sales could proceed. Since the Board had conceded that there were hazards, and since those hazards seemed similar, or identical, to the hazards that motivated Congress to enact the Glass-Steagall Act, it appeared incongruous that the Board should reject the applicability of the Act and then seek to control the hazards by fiat pursuant to its generalized authority to protect the safety and soundness of member banks. This seemed like a thinly disguised end run around the statute. The Board's orders thus "effectively convert[ed] a portion of the Act's broad prohibition into a system of administrative regulation."⁵⁵

The Court's second principal objection was that the banking industry itself had apparently accepted its exclusion from commercial paper dealings without protest for nearly fifty years. As the Court observed, "it is certainly not without some significance that Bankers Trust's commercial-paper placement activities appear to be the first of that kind since the passage of the [Glass-Steagall] Act."⁵⁶ The Court observed that banks had "universally recognized" that underwriting commercial paper fell on the investment banking side of the Glass-Steagall divide.⁵⁷

Accordingly, the Supreme Court's role at this stage of the controversy appears to have been a conservative one: preserving the status quo under which banks did not deal in commercial paper, championing a perceived congressional intent, and resisting administrative tinkering with the statute for contemporary policy purposes.

The securities industry's apparent victory in the *Bankers Trust I* case did not end the dispute, however. At the end of its opinion, the Court dropped a suggestive footnote, observing that it was not deciding whether the activities undertaken by Bankers Trust constituted the "underwriting" of securities. This was important. Section 16 of the Glass-Steagall Act prohibited only commercial bank involvement in the "underwriting" of securities.⁵⁸ Securities brokerage, as opposed to underwriting, appeared to be expressly allowed by the Act, which recognized the power of commercial banks to purchase and sell securities "without recourse, solely upon the order, and for the account of, customers."⁵⁹ Section 21 of the

⁵⁵ *Bankers Trust I*, 468 U.S. at 153.

⁵⁶ *Id.* at 159-60.

⁵⁷ *See id.* at 160.

⁵⁸ *See id.* at 160 n.12.

⁵⁹ *See* 12 U.S.C. § 24, para. 7 (1988).

Act only prohibited firms engaged in "the business" of underwriting or distributing securities from acting as depository institutions.⁶⁰ Bankers Trust's commercial paper operations would not violate the Glass-Steagall Act if they did not constitute "underwriting" or "distributing" commercial paper. Thus the Supreme Court's 1984 decision merely represented a battle won by the securities industry, but did not resolve the war.

On remand, the Board decided that the Bankers Trust placement of commercial paper constituted the selling of securities without recourse and solely on the order and for the account of a customer, a practice permitted by sections 16 and 21 of the Act.⁶¹ The decision went on to conclude that Bankers Trust was not "underwriting" securities because the term "underwriting" in the Act referred only to public offers, not to private placements of the sort undertaken by Bankers Trust. A federal district court reversed,⁶² but the D.C. Circuit reinstated the Board's decision. It concluded that the Board's interpretation of the statute was entitled to deference and that the Bankers Trust program did not pose the sort of subtle hazards that the Supreme Court had considered in its earlier decision (*Bankers Trust I*).⁶³ Bankers Trust, accordingly, was free to proceed with its commercial paper placement program.

B. *The Bankers Trust Initiative in Underwriting Commercial Paper*

So far, Bankers Trust and, by implication, other member banks had gained only the power to act as agents in the placement of commercial paper. Underwriting would clearly be prohibited if performed by the banks. This meant that as a practical matter Bankers Trust could not purchase for its own account commercial paper which it was placing with other investors. According to Bankers Trust officials we interviewed, this limitation placed Bankers Trust at a competitive disadvantage relative to securities firms which were free from similar constraints;⁶⁴ Bankers Trust

⁶⁰ See *id.* § 378(a)(1).

⁶¹ The unpublished opinion is described in *Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys.*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) [hereinafter *Bankers Trust II*].

⁶² *Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys.*, 627 F. Supp. 695 (D.D.C. 1986), *rev'd*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

⁶³ See *Bankers Trust II*, 807 F.2d at 1067-70.

⁶⁴ See Parisi interview, *supra* note 24.

would be required to sell all of its customers' paper on the day of issue; if any were left over at the close of the day Bankers Trust could not purchase it. Bankers Trust proposed to the Board that it be allowed to make up any shortfall with a loan to the issuer at the commercial paper rate, but the Board refused.⁶⁵ Thus, Banker's Trust had gained a toehold, but not yet a position of competitive equality with securities firms: it could not underwrite commercial paper, nor could it make up shortfalls at the close of the day.

Bankers Trust and other large money center banks responded to this limitation in two ways. First, sometime in 1985, they developed a new financial product, the short-term securitized loan, as a partial substitute for commercial paper.⁶⁶ A bank would originate a loan with a maturity and interest rate similar to that of commercial paper, and then sell interests in the loan to other institutions. The effect is functionally similar to a commercial paper placement, but because the transaction is structured as a loan instead of a distribution of securities, the Glass-Steagall Act does not constrain the originating bank from taking an interest in the loan—i.e., from acting in a role functionally equivalent to underwriting.

Second, Bankers Trust applied to the Board of Governors for permission under the Bank Holding Company Act⁶⁷ to transfer its commercial paper activities to a second-tier subsidiary of the parent bank holding company. The Chicago-based subsidiary, BT Commercial Corporation, was engaged in making and servicing loans and in commercial leasing, activities previously declared by the Board to be permissible for nonbank subsidiaries of bank holding companies under the Bank Holding Company Act.⁶⁸ Bankers Trust's motive

⁶⁵ See *id.*

⁶⁶ See *id.*

⁶⁷ Section 4(c)(8) of the Bank Holding Company Act of 1956, 12 U.S.C. § 1843(c)(8) (1988), permits bank holding companies to maintain nonbank subsidiaries, provided that the subsidiary's activities are "so closely related to banking or managing or controlling banks as to be a proper incident thereto . . ." Federal Reserve Board approval is required before a nonbank subsidiary may enter into any new line of business. At the time of the Bankers Trust application, the Federal Reserve Board had exempted a number of nonbanking activities either by order or in its Regulation Y, 12 C.F.R. § 225 (1990), but it had never addressed the question of whether commercial paper placement was permissible for a nonbank subsidiary.

⁶⁸ See Fidelity American Bankshares, Inc., Fed. Res. Bd. Order, [1972-1973 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 95,832, at 80,761-2 (Dec. 14, 1972) (holding that providing and servicing loans is "closely related to the business of banking" and, therefore, permissible for bank holding companies); Leasing Computer Equipment and Lease Financing, [1972-1973 Transfer Binder] Fed. Banking L. Rep.

in moving the commercial paper business over to its holding company did not arise out of a concern for short-term profit; in all probability, commercial paper placement per se could not be performed more efficiently out of a commercial finance subsidiary than out of the bank itself. Moreover, there was no obvious advantage (and perhaps some disadvantage) to running the commercial paper operation out of Chicago instead of New York. Although placing the operation in a nonbank bank holding company subsidiary offered the potential for geographic diversification free of restrictions under the Douglas Amendment to the Bank Holding Company Act,⁶⁹ there is no indication in the record that Bankers Trust intended to expand its commercial paper placement operations outside of Chicago. The most likely explanation is that the application was a strategic move designed as part of a long-range plan to position Bankers Trust as a leading commercial bank presence in the investment banking field, and, in particular, to allow eventual securities underwriting.

Bankers Trust had every reason to expect a favorable response to its application. The Board itself, and most importantly its powerful Chairman, Paul A. Volcker, had gone on record as supporting enhanced securities powers for bank holding companies, including the power to deal in commercial paper;⁷⁰ and the Bankers Trust application provided the Board with a convenient

(CCH) ¶ 95,716 (June 29, 1972) (noting that transactions where a lease is the functional equivalent of an extension of credit to the lessee are permissible for bank holding companies).

⁶⁹ The Douglas Amendment to the Bank Holding Company Act of 1956, 12 U.S.C. § 1842(d) (1988), permits bank holding companies to own subsidiary banks outside their home state only if the state where the subsidiary is located has enacted legislation permitting the acquisition. *See also* Northeast Bancorp, Inc. v. Board of Governors of the Fed. Res. Sys., 472 U.S. 159, 168-73 (1985) (interpreting the Douglas amendment).

⁷⁰ *See, e.g., Structure and Regulation of Financial Firms and Holding Companies (Part I): Hearings Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations, 99th Cong., 2d Sess. 165 (1986) (statement of Paul A. Volcker), reprinted in 72 Fed. Res. Bull. 541, 549 (1986) (noting that the Board has long supported an approach that would permit subsidiaries of bank holding companies to engage in underwriting and distributing commercial paper); Financial Restructuring: The Road Ahead: Hearings on H.R. 5342, H.R. 4506 and H.R. 3537 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, H.R. REP. NO. 144, 98th Cong., 2d Sess. (1984) (statement of Paul A. Volcker), reprinted in 70 Fed. Res. Bull. 312, 316 (1984) (noting the need to reexamine the limitations of banking organizations in light of the market changes, changes in technology, consumer needs, and the regulatory and economic environment).*

means for accomplishing this policy objective.⁷¹ Indeed, Bankers Trust probably had received informal prior assurances from Board staff that its application would not be unwelcome.⁷² We were informed by a Bankers Trust official that the bank frequently consulted with the Board on a friendly and informal basis on the commercial paper question.⁷³

The Bankers Trust application implicated section 20 of the Glass-Steagall Act,⁷⁴ which prohibits affiliations between member banks and organizations “engaged principally” in the securities business.⁷⁵ The Board held that actions permitted to a bank itself under sections 16 and 21 should not be denied to a bank affiliate under section 20.⁷⁶ Thus, because the Board had previously approved commercial paper placement activities by the bank itself, and that approval had been upheld by the D.C. Circuit,⁷⁷ the activity was permissible a fortiori for nonbank subsidiaries of bank holding companies.

The Board could have ended its analysis of the Glass-Steagall Act at this point, but it went on to provide an alternative basis for decision: even if the activities in question *did* constitute “underwriting” under section 20, they would not violate the Glass-Steagall Act because the securities subsidiary would not be “engaged principally” in such activity.⁷⁸ The Board held that the term “engaged princi-

⁷¹ The Board could, in theory, have proceeded by informal rulemaking, amending Regulation Y to include acting as agent in the sale of commercial paper as part of the Regulation Y “laundry list” of activities generally permitted to nonbank subsidiaries of bank holding companies. However, the Board has traditionally added activities to Regulation Y only after determining by order in one or more concrete cases that the activity in question was permissible. Thus an initial rulemaking approach would have been out of the ordinary course and would have received attention in Congress and elsewhere. The Board may not have wanted to dramatize its action in this fashion.

⁷² See *supra* note 34.

⁷³ See Interview with James Beckley (Apr. 11, 1989).

⁷⁴ 12 U.S.C. § 377 (1988).

⁷⁵ Section 20 provides, in pertinent part, that “no member bank shall be affiliated . . . with any . . . organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . .” See *id.* Congress extended this provision to insured nonmember banks in the Competitive Equality Banking Act of 1987, Pub L. No. 100-86, § 103, 101 Stat. 552, 566-67 (1987).

⁷⁶ See Bankers Trust New York Corporation, 73 Fed. Res. Bull. 138, 139-40 (1987) (citing Board of Governors of the Fed. Res. Sys. v. Investment Co. Inst., 450 U.S. 46, 60 n.26 (1981)).

⁷⁷ See Bankers Trust II, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

⁷⁸ See Bankers Trust New York Corp., 73 Fed. Res. Bull. at 145-46.

pally” meant “any substantial line of business activity.”⁷⁹ It concluded that the subsidiary would not be engaged principally in the securities business if its gross revenues from commercial paper activities constituted less than five percent of its total gross revenues and the company’s total commercial paper outstanding represented less than five percent of the average amount of all dealer-placed commercial paper outstanding.⁸⁰

The Board then examined the legal issues arising under the Bank Holding Company Act.⁸¹ It held, first, that the proposed activities would be “closely related to banking” because commercial paper placement is similar to the traditional banking function of arranging loan participations with other banks and other institutional lenders.⁸² It then held that the proposed activity represented a “proper incident” to banking because the public benefits of the activity (increased competition and greater customer convenience) outweighed the potential adverse effects (such as unfair competition, insider trading, and under concentration of resources).⁸³ The Board therefore approved the application, subject to several constraints proposed by Bankers Trust itself.⁸⁴

The Board’s decision to allow a bank holding company subsidiary to place commercial paper left open the question of whether it would be permissible for such a subsidiary to *underwrite* commercial paper—that is, to purchase such paper for its own account for resale to customers at a profit. That question came to the Board a few months later in the form of an application by The Chase Manhattan Corporation to underwrite and deal in third party commercial paper to a limited extent through a commercial finance subsidiary. The Board, relying on its earlier Bankers Trust decision, held that the

⁷⁹ *Id.* at 142.

⁸⁰ *See id.* at 146.

⁸¹ *See supra* notes 67-69 and accompanying text.

⁸² Bankers Trust New York Corporation, 73 Fed. Res. Bull. at 147.

⁸³ *See id.* at 152.

⁸⁴ Among other limitations, the Board ruled that the subsidiary could place only prime quality short-term paper in minimum denominations of \$250,000; could place the paper only with sophisticated financial institutions; could not inventory unsold portions of the paper it placed, nor purchase such paper for its own account; could not earn revenues from commercial paper placement exceeding five percent of gross revenues in any given year; could not achieve a market share exceeding five percent of all dealer-placed paper at any one time; could not back the paper with which it dealt by letters of credit or guarantees; could not extend credit to issuers to cover unsold paper; could not provide investment advice to purchasers; and could not have officers, directors, or employees in common with any of the holding company’s subsidiary banks. *See id.* at 152-53.

Chase subsidiary would not be “engaged principally” in the securities business, even though it would be underwriting rather than acting as agent, so long as it adhered to the five percent revenue limitation.⁸⁵ Relying on the Bankers Trust decision, it held further that the proposed commercial paper underwriting was a permissible activity for nonbank subsidiaries of bank holding companies under the Bank Holding Company Act, provided that the Chase subsidiary adhered to the limitations on operations imposed by the Board in the *Bankers Trust New York Corporation* case.⁸⁶

C. Further Breaches in the Glass-Steagall Barrier

The logic of these decisions was not limited to commercial paper. If a nonbank subsidiary could sell commercial paper as agent or underwriter, there was no apparent reason under the language of the Glass-Steagall Act why such an organization could not broker or sell all forms of securities, provided that the activity in question was not so substantial as to run afoul of the proscription in section 20 against “engag[ing] principally” in the securities business.⁸⁷ Although commercial paper marked the entering wedge into the securities business, it was clear that applications for other securities activities would not be far behind.

Indeed, at the time it decided the *Bankers Trust New York Corporation* and the *Chase Manhattan Corporation* cases, the Board had pending before it just such an application.⁸⁸ Three bank holding companies—Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corporation—sought approval for nonbank subsidiaries to underwrite municipal revenue bonds, mortgage-related securities, consumer-receivable-related securities, and commercial paper. The subsidiaries designated to engage in these activities were then engaged in underwriting securities such as U.S. government and agency and state and municipal securities (“bank-eligible” securities) that member banks are permitted to underwrite under section 16 of the Glass-Steagall Act.⁸⁹

⁸⁵ See *Chase Manhattan Corp.*, 73 Fed. Res. Bull. 367, 368 (1987).

⁸⁶ See *id.* at 371. The D.C. Circuit upheld the Board’s decision in *Securities Indus. Ass’n v. Board of Governors of the Fed. Res. Sys.*, 847 F.2d 890 (D.C. Cir. 1988).

⁸⁷ 12 U.S.C. § 377 (1988).

⁸⁸ See *Chase Manhattan Corp.*, 73 Fed. Res. Bull. at 371.

⁸⁹ See *Citicorp/J.P. Morgan & Co./Bankers Trust*, 73 Fed. Res. Bull. 473, 473 (1987).

The *Citicorp/J.P. Morgan & Co./Bankers Trust* cases represented two further steps by commercial banks into the securities business. First, aside from commercial paper underwriting, which the Board had approved as closely related to banking in the *Chase Manhattan Corporation* case,⁹⁰ the securities involved in the later applications were relatively far-removed from the traditional banking business. It was unclear whether underwriting these securities would pass muster under the Bank Holding Company Act. Second, because the subsidiary companies in question were involved in underwriting government securities, there was a close question as to whether the existing business of these firms would be considered the "securities" business for purposes of section 20. If so, then the petitions would have to be denied because the subsidiary would be principally engaged (indeed, wholly engaged) in the securities business in violation of section 20. If, on the other hand, bank-eligible activities were excluded from the securities business to which section 20 applies, then the petitions might well be upheld because the bank-ineligible portion of the business might be considered insubstantial in comparison with the total volume of business conducted by the firm.

The applications thus raised important issues for the future of the financial services industry. The three bank holding companies sought, in essence, to be allowed to operate large-scale investment banking affiliates engaged in underwriting a wide variety of securities. Even the stringent five percent revenue test imposed by the Board in prior cases would not restrict seriously the operation of these proposed section 20 affiliates, at least not in the short run, because as primary dealers in government securities the firms brought in such an enormous amount of revenue that there were few practical impediments to conducting a full-scale underwriting business. In short, while approval of these applications did not quite have the potential of eviscerating the Glass-Steagall Act, it did create the possibility of allowing the kind of bank involvement in the securities business that the Act had long been thought to prohibit.

The Board approved the applications by a split decision, with Chairman Volcker and Governor Angell dissenting.⁹¹ The majority rejected the contention that bank-eligible securities such as U.S.

⁹⁰ See *Chase Manhattan Corp.*, 73 Fed. Res. Bull. at 368.

⁹¹ See *Citicorp/J.P. Morgan & Co./Bankers Trust*, 73 Fed. Res. Bull. at 505-06.

government obligations fell within the term "securities" in section 20 of the Glass-Steagall Act, observing that such an interpretation would be inconsistent with the evident congressional intent to impose less burdensome restrictions on securities activities by affiliates than on activities by banks themselves.⁹² The Board then applied its five percent gross revenue and market share limitations to the proposals in determining that the proposed bank-ineligible activities would not violate section 20's proscription against an affiliate being "engaged principally" in bank-ineligible securities activities.⁹³

The Board then addressed the Bank Holding Company Act issues, and upheld as closely related to banking the proposals for underwriting commercial paper,⁹⁴ municipal revenue bonds, and 1-4 family mortgage-related securities.⁹⁵ Finally, the Board held that the public benefits of the proposals outweighed the possible adverse effects, provided that the activities were limited in scope and effect as provided in a rather extensive list of "firewall" restrictions set forth in the Board's opinion.⁹⁶ The Board emphasized that these limitations were "prudential" and that it believed it appropriate to "proceed cautiously" in view of the fact that the proposals "represent the first major entry of banking organizations into the field of underwriting and dealing in ineligible securities"⁹⁷ It warned that it might tinker with the limitations in the future.⁹⁸

Chairman Volcker and Governor Angell dissented on the ground that bank-eligible securities were "securities" within the meaning of section 20. They emphasized that they agreed with the Board's decision as a policy matter, but believed that it contravened the intent of Congress underlying the Glass-Steagall Act:

The interpretation adopted by the majority would appear to make feasible, as a matter of law if not Board policy, the affiliations of banks with some of the principal underwriting firms or investment

⁹² See *id.* at 478-81.

⁹³ See *id.* at 481-85.

⁹⁴ This issue had already been decided in the Chase Manhattan Corporation case. See *Chase Manhattan Corp.*, 73 Fed. Res. Bull. at 368.

⁹⁵ See *Citicorp/J.P. Morgan & Co./Bankers Trust*, 73 Fed. Res. Bull. at 487. The Board did not decide on the record before it whether consumer-receivable-related securities met the "closely related" test.

⁹⁶ See *id.* at 502-05.

⁹⁷ *Id.* at 504.

⁹⁸ See *id.*

houses of the country. Such a legal result, we feel, is inconsistent with the intent of Congress in passing the Glass-Steagall Act.⁹⁹

The Board's decision in *Citicorp/J.P. Morgan & Co./Bankers Trust* represented a severe, although not entirely unexpected, setback to the Securities Industry Association. But that group had not been idle. Knowing that the Board was likely to approve further intrusions by banks into the securities business, the SIA had lobbied for, and obtained, a provision in banking legislation pending on Capitol Hill that would impose a moratorium on Board approval between March 6, 1987 and March 1, 1988 of any application which would permit a bank holding company to engage in the underwriting or public sale of securities on the basis that it was not "engaged principally" in such activity within the meaning of section 20 of the Glass-Steagall Act. The provision passed the Senate on March 27, 1987;¹⁰⁰ not coincidentally, the decision in *Chase Manhattan Corp.* came down on March 18, prior to the Senate's action but after the effective date of the proposed moratorium. This provision became § 201(b) of the Competitive Equality Banking Act of 1987.¹⁰¹ Thus the securities industry had obtained at least a temporary reprieve from the depredations of the Federal Reserve Board.

The SIA then petitioned the Second Circuit for review of the Board's *Citicorp/J.P. Morgan & Co./Bankers Trust* order. The petition could have been taken up to the D.C. Circuit, but the SIA apparently concluded that its loss in *Bankers Trust II* did not auger well for future litigation in that forum. The Second Circuit, however, proved no more receptive, rejecting the SIA's petition in

⁹⁹ *Id.* at 505.

¹⁰⁰ See S. 790, 100th Cong., 1st Sess., 133 CONG. REC. 4061, 4067 (1987).

¹⁰¹ Pub. L. No. 100-86, § 201(b), 101 Stat. 552, 582-83 (to be codified at 12 U.S.C. § 1841). The provision states that between March 6, 1987 and March 1, 1988, [a] Federal banking agency may not authorize or allow by action, inaction, or otherwise any bank holding company or subsidiary or affiliate thereof . . . to engage in the United States to any extent whatever . . . in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such activities"

Id.

Section 202 of the statute permitted the Board to issue an order during the moratorium period pursuant to its pre-existing authority if the effective date of the order was delayed until the expiration of the moratorium. See *id.* at 584.

all respects in February 1988 (*Bankers Trust III*).¹⁰² The Second Circuit reversed the Board only on its market share limitation—the subject of a cross-petition by the bank holding companies—finding no evidence that Congress intended to limit the activities of securities affiliates under section 20 through any market share test.¹⁰³

Meanwhile the securities and banking industries made use of the one-year moratorium to fight a pitched battle on Capitol Hill over proposals to reform or repeal the Glass-Steagall Act. The securities industry's apparent strategy in obtaining the moratorium was to force the issue of Glass-Steagall reform onto the congressional agenda, and to obtain by legislation some sort of accommodation under which securities firms would be allowed into the banking business if banks were allowed into the securities business. This strategy seemed near success when the Chairperson and the ranking minority member of the Senate Banking Committee, Sen. William Proxmire and Sen. Jake Garn, proposed legislation that would have allowed banks to form securities affiliates and securities firms to form banking affiliates.¹⁰⁴ However, despite much activity, Congress was unable to agree on legislation and the moratorium expired.¹⁰⁵ The Board's orders remained in effect, however, although they had been stayed pending Supreme Court action on the SIA's petition for a writ of certiorari in *Bankers Trust III*. Members of Congress began to make statements, apparently at the behest of the securities industry, encouraging the Supreme Court to grant the writ of certiorari and imploring the Court not to draw any inferences from Congress's failure to act during the moratorium¹⁰⁶ or to assume that Congress would be able to resolve the

¹⁰² Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys., 839 F.2d 47 (2d Cir.), cert. denied, 486 U.S. 1059 (1988) [hereinafter *Bankers Trust III*].

¹⁰³ See *id.* at 67-68.

¹⁰⁴ See S. 1886, 100th Cong., 1st Sess., 133 CONG. REC. 16,659-67 (1987) (remarks of Sen. Proxmire) (outlining the text of the proposed act and stating that the legislation is necessary to modernize and constructively reshape our financial institutions).

¹⁰⁵ Seven bills to amend or repeal the Glass-Steagall Act were pending before the House Banking Committee at one time. The Chairperson of the Committee, Rep. St Germain, directed the staff to prepare a compromise committee draft, but the committee was unable to report out a bill. See 134 CONG. REC. E1,473 (daily ed. May 10, 1988) (remarks of Rep. Morrison).

¹⁰⁶ See 134 CONG. REC. E1,636-37 (daily ed. May 19, 1988) (remarks of Rep. Rinaldo); 134 CONG. REC. E1,473 (daily ed. May 10, 1988) (remarks of Rep. Morrison).

controversy at any time during the present geologic era.¹⁰⁷ The Supreme Court, unmoved, denied the writ.¹⁰⁸

D. *Recent Developments*

At this point, the initial political battle over commercial paper was over. Banks and bank holding companies could place an unlimited amount of commercial paper for the accounts of issuers, and could underwrite commercial paper through a nonbank subsidiary up to the point where gross revenues from commercial paper underwriting and other bank-ineligible securities activities equalled five percent of the subsidiary's gross revenues. From a regulatory perspective, the battle now turned to the question of whether the prudential limits ("firewalls") on section 20 firms would be lifted, and if so, how soon.

The revenue limitation was not a serious constraint for large bank holding companies with subsidiaries that functioned as primary dealers in government securities. The amount of bank-eligible securities revenues brought in by these firms was so large that even very substantial underwriting was possible within the revenue cap.¹⁰⁹ The same was not true, however, for smaller or regional bank holding companies that did not control large primary dealers in government securities. These firms could operate section 20 subsidiaries only at a relatively low volume of business, a factor which as a practical matter meant that they could not operate

¹⁰⁷ See 134 CONG. REC. E1,473 (daily ed. May 10, 1988) (remarks of Rep. Morrison) ("I hope the Supreme Court will not decline to grant review on the assumption that this Congress will enact legislation resolving the issues in the case. While this is what we should and perhaps can do, realistically speaking, the enactment of banking legislation in this Congress is very uncertain.").

¹⁰⁸ 486 U.S. 1059 (1988).

¹⁰⁹ See Garsson, *Limited Value Seen in Power to Underwrite*, AM. BANKER, Feb. 20, 1990, at 1 (noting that revenue limit has not proved a hindrance at Bankers Trust). Securities affiliates of big banks earn bank-eligible revenues through acting as primary dealers in Treasury securities, as well as through bank-eligible private placements which are likely to increase in number as a result of the newly-adopted SEC Rule 144A, Private Resales of Securities to Institutions, Securities Act Release No. 33-6862, Fed. Sec. L. Rep. (CCH) ¶ 84,523 (Apr. 30, 1990). This should greatly increase the attractiveness of private placements by allowing rapid development of a secondary market in privately placed securities. See Rehm, *Fed Expected to Ease Limit on Securities: Ruling Likely to Boost Underwriting Capacity*, AM. BANKER, Oct. 30, 1989, at 1. *But see Will the 144A Market Be Slow Off the Mark?*, INST. INVESTOR, May 1990, at 25 (noting that "now it looks as if [Rule 144A which] was touted as transforming the way capital is raised in the U.S. could take a while to lure significant members of issuers and investors").

section 20 securities subsidiaries at all.¹¹⁰ When regional banks and bank holding companies made their unhappiness with this situation known,¹¹¹ the Board responded by raising the cap to ten percent, a level which should eventually allow a substantially larger number of bank holding companies to enter the securities business through section 20 subsidiaries.¹¹²

Bank holding companies also chafed under the prudential or "firewall" limitations applicable to transactions between the securities affiliate and the parent holding company. They claimed that some of these limitations were unnecessary and that compliance costs were high.¹¹³ It is widely expected that the Board will reconsider its firewalls after an appropriate time in which the actual operations of section 20 subsidiaries can be observed.¹¹⁴ At present, the stringency of the Board's firewalls is a matter of intense controversy within the banking and securities industries.

Finally, with respect to banks, the Board in 1989 issued an order allowing section 20 affiliates to underwrite and deal in corporate bonds, including junk bonds, and, after a waiting period, in corporate equity securities as well.¹¹⁵ The D.C. Circuit upheld

¹¹⁰ See Parisi interview, *supra* note 24; see also Garsson, *supra* note 109, at 1 (noting that except for large money-center banks, even large regional banks cannot generate enough bank-eligible revenue to make a profit in bank-ineligible activities).

¹¹¹ See Horowitz, *Fed May Expand Securities Powers*, AM. BANKER, Sept. 13, 1989, at 1, col. 1, 18, col. 3 (quoting an official of PNC Financial Corp., a regional bank holding company: "For a regional company of our size it doesn't make sense to engage in all four product lines [of bank-ineligible securities authorized by the Board] unless we can do a large amount in each particular line"); Horowitz, *Regionals Go Slow on Underwriting: They Let Money Center Banks Take the Lead on Section 20*, AM. BANKER, Aug. 29, 1989, at 5; Rehm, *Bank Victories on Securities Mostly Symbolic*, AM. BANKER, Apr. 12, 1990, at 1, 13 (discussing Security Pacific Corp., a large regional bank, which has yet to implement its securities powers because of the burdens of firewall restrictions).

¹¹² See *Modifications to Section 20 Orders*, 75 Fed. Res. Bull. 751 (1989).

¹¹³ See, e.g., Garsson, *supra*, note 109, at 1, col. 1 (noting that Bankers Trust was forced to move clearing operation for non-Treasury securities out of its securities affiliate because of firewall prohibiting loans between insured banks and securities affiliate).

¹¹⁴ The Board expressly indicated that it might revisit and revise the firewalls in the future. See Citicorp/J.P. Morgan & Co./Bankers Trust, 73 Fed. Res. Bull. 473, 504-05 (1987).

¹¹⁵ See J.P. Morgan & Co., Inc., 75 Fed. Res. Bull. 192 (1989). The Board's action was apparently taken with careful attention to its political consequences. As to bond underwriting, the Board was well aware that many potential opponents of expanded bank powers had voted during the previous year to allow banks to underwrite corporate bonds; those members were thus hampered in their ability to complain when the Board accomplished the same result by regulation. As to equity underwrit-

this order in April 1990.¹¹⁶ Thus, banks are now able, through their securities affiliates, to engage in a wide range of securities activities, subject to the requirement that the gross revenues from the bank-ineligible activities not exceed ten percent of the affiliate's total revenues, and subject also to the various firewalls against transactions between securities affiliates and other parts of the bank holding company. The securities affiliates of banks live again—despite the nearly universal belief for nearly a half-century that they had been forever destroyed by the Glass-Steagall Act of 1933.

Securities firms, for their part, have faced still further difficulties over the past few years. First, the legal developments which have allowed bank affiliates to underwrite securities have not benefitted them. All the major securities firms are “engaged principally” in bank-ineligible activities. Accordingly, they cannot affiliate with banking institutions by setting themselves up as section 20 subsidiaries of bank holding companies. Nor, under section 21, can they engage “to any extent whatever” in deposit banking either directly or through a subsidiary. In short, while the Glass-Steagall Act has proved to be relatively toothless when applied to securities activities by big bank holding companies, it retains a great deal of bite as applied to banking activities by the big securities firms.

This suggests that the value of the Glass-Steagall Act in protecting securities firms against bank competition may have been eroded to the point where the securities industry as a whole might not be severely damaged by repeal of the Act. In May 1990, the Securities Industry Association took the fateful step of dropping its opposition to repeal of the Glass-Steagall Act.¹¹⁷ The United States appears

ing, the Board, while approving the activity itself, announced that it would not grant any actual approvals for a year. This deferral ostensibly allowed Congress a period of time in which to reverse the Board, thus deflecting potential congressional criticism. Given the paralysis that Congress has displayed on Glass-Steagall issues, few observers seriously believed that Congress would reverse the Board's order. See Rehm, *Fed Ruling Leaves Congress Leeway*, AM. BANKER, Jan. 20, 1989, at 1, 16. As expected, Congress took no action.

¹¹⁶ See *Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys.*, 900 F.2d 360 (D.C. Cir 1990) [hereinafter *Bankers Trust IV*]. The Court held that, having lost on essentially the same arguments in the Second Circuit in *Bankers Trust III*, 839 F.2d 47, *cert. denied*, 486 U.S. 1059 (1988), the SIA was estopped from relitigating the issue in the D.C. Circuit.

For a discussion of the potentially greater implications of the Fed's recent decision to allow commercial banks to underwrite securities, see Sease, *supra* note 12, at C1, col. 5.

¹¹⁷ See *Securities Industry Accepts Glass-Steagall is Doomed*, FIN. TIMES INT'L BANKING REP., June 1990.

to be taking the first groping steps towards a European-style system of universal banking in which a single organization offers a full array of banking, securities, and other financial services.

As a result of the developments recounted above, much of the conflict between banks and securities firms has now been redirected from the political to the marketplace arena. It was one thing for bank holding companies to achieve the formal power to engage in securities underwriting; it is quite another to establish a section 20 underwriting affiliate able to compete on equal terms with established securities firms. Moreover, the securities industry itself recently has faced a series of painful shocks, including the market break of October 1987, the slowdown in corporate takeover activity starting in 1988, the bankruptcy of Drexel Burnham Lambert in late 1989, the ensuing collapse of the junk bond market, and the downturn in the stock market stimulated by the Iraqi invasion of Kuwait. Profits of securities firms were down, and a number of firms had to lay off employees in 1990. Given these developments, it is hardly surprising that a number of bank holding companies that obtained permission to open section 20 subsidiaries have not yet done so, apparently out of concern that they can not compete in an already packed market.¹¹⁸ One bank holding company closed its section 20 affiliate only two years after its creation.¹¹⁹ Those that continue to operate section 20 subsidiaries have focused their business almost exclusively in the area of commercial paper.¹²⁰

¹¹⁸ See GAO Report: "Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies," *Hearings Before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 106 (1990) [hereinafter GAO Report] (as of September 30, 1989, 21 holding company subsidiaries had received permission to conduct bank-ineligible activities, but only 13 had actually commenced such activities).

¹¹⁹ See Leander, *Bank of Boston Closes Sec. 20 Unit*, AM. BANKER, June 5, 1990, at 2.

¹²⁰ See GAO Report *supra* note 118, at 60-61. Commercial paper represented approximately 98% of bank-ineligible activities by § 20 firms between the third quarter 1988 and the third quarter 1989. For example, in the third quarter of 1989, § 20 affiliates underwrote \$386 million in municipal revenue bonds, \$600 million in mortgage-related securities, \$45 million in asset-backed securities, and \$67,660 million in commercial paper. See *id.* Although a number of § 20 firms had announced plans to enter the junk bond field, as of May 1990 none had done so. See Smith, *Banks See Golden Opportunity in Junk*, Wall St. J., May 15, 1990, at C1, col. 3. In June 1990, Citicorp announced that it was terminating its municipal securities underwriting business. See Guenther, *Citicorp Will End Its Underwriting of Municipal Issues*, Wall St. J., June 5, 1990, at C21, col. 1.

It is not yet clear whether section 20 firms will be able to survive in the highly competitive commercial paper market. Market participants we interviewed said that spreads were so low in 1989 that it was very difficult to make a profit in commercial paper underwriting.¹²¹ An officer at Merrill Lynch Capital Markets estimated that in the spring of 1989 the three leading section 20 firms, BT Securities Corp. (the Bankers Trust New York Corporation subsidiary), Citicorp Securities Markets, Inc., and J.P. Morgan Securities, Inc., each had approximately \$15 billion outstanding in commercial paper underwritings, while the break-even point for this business was approximately \$28 billion.¹²² The section 20 firms were almost certainly operating at a loss during this period.

Although section 20 firms may not yet be turning a profit, the trend for bank commercial paper underwriting has been dramatically positive, with total commercial paper underwritten by section 20 firms rising from approximately \$12 billion in the third quarter of 1988 to approximately \$68 billion in the third quarter 1989.¹²³ Recent press accounts indicate that banks continue to do well in this field.¹²⁴ Banks such as Bankers Trust and Citicorp show every sign of being committed to the commercial paper market for the long haul, both as a means of gaining an initial toehold in the securities business and as a device for maintaining and enhancing contact with their prime commercial customers.¹²⁵ In short, there can be little doubt that the government decision to permit commercial banks to enter the commercial paper market had a significant economic impact.

¹²¹ See Fuscone & Smithwick interview, *supra* note 38; Parisi interview, *supra* note 24. Spreads have been low for a number of years, forcing major players such as Salomon Brothers and Paine Webber to abandon the business. See Tobin, *Players Reshuffled in CP Market*, EUROMONEY, June 1988, at 175.

¹²² See Parisi interview, *supra* note 24.

¹²³ See GAO Report, *supra* note 118, at 106; see also, Quint, *Turning the Tables*, U.S. BANKER, July 1988, at 14 (1988) (reporting the growing number of banks successfully entering the commercial paper market).

¹²⁴ See Tobin, *supra* note 121, at 175; Neustadt, *supra* note 38, at 1, col. 4.

¹²⁵ See Rehm, *supra* note 111, at 1, col. 1 (reporting that NCNB Corp., a large regional bank holding company, decided to activate a securities affiliate because, over time, the value of bank powers will grow, and because NCNB wanted to obtain grandfather rights in the event that Congress chose to bar further investment banking affiliates); see also Garsson, *supra* note 109, at 1, col. 1 (noting that the most important aspect of new bank powers is that banks have "an opportunity to become familiar with corporate debt and equity underwriting in anticipation of full-scale repeal of the Glass-Steagall Act").

III. THE JAPANESE EXPERIENCE

A. *The Controversy in the Diet*

As previously discussed, commercial paper did not exist in Japan prior to the recent controversy. In fact, the essence of the controversy was not the question of who would control the commercial paper market, as it was in the United States, but rather whether a commercial paper market should exist at all. Once this question was raised, however, the conflict between banks and securities firms quickly came to the forefront.

That conflict, although built into the structure of the Japanese financial services industry by the Securities Exchange Law (SEL) and its article 65, had long remained dormant. The Tokyo Stock Exchange was bombed into ruins during World War II and had yet to reopen in 1948, the time of the SEL's passage. Banks were preoccupied by efforts to stay afloat given the massive damage that the war had caused. With the general revival of the economy and the banking sector during the Korean War boom, the banks began to flourish and became the main suppliers of funds to Japan's ever-expanding industrial sector. Throughout the high-growth era, banks were highly profitable relative to the rest of Japanese industry as they were able to enjoy the fruits of their regulated market. The underdeveloped securities market offered few temptations.

In the 1970s, however, changes in the Japanese economy began to destabilize the balance between banks and securities firms.¹²⁶ Perhaps the most significant change was the gradual erosion of the banks' most lucrative form of business—providing credit to Japanese industrial firms. In a mature economy, these firms were no longer as desperate for credit as they had been previously. Some, such as Toyota, amassed huge amounts of surplus cash, and, insulated from the threat of hostile takeovers, used this cash to finance themselves, rather than distributing it to shareholders. Others took advantage of new ways to raise capital that were more flexible and less expensive than bank loans, such as issuing convertible bonds or selling securities in the newly-accessible Euromarket.

A second problem for commercial banks, of a more technical but still significant nature, came in the area of government bonds. Government bonds had historically been underwritten by syndicates of commercial banks, with resales forbidden. Banks were willing to

¹²⁶ See F. ROSENBLUTH, *supra* note 28, at 4.

underwrite the bonds despite their low interest rates because the Bank of Japan would buy them up in open market operations soon after issuance, in order to expand gradually the money supply. The system broke down, however, when the Japanese government began to issue a huge volume of deficit-finance bonds in 1976-77. The Bank of Japan could no longer purchase all or even most of the bonds, as such purchases would have resulted in an inflationary overexpansion of the money supply. Left holding large, unprofitable government bond portfolios, the banks demanded the ability to sell these bonds to the general public. There followed a lengthy debate involving the banking and securities industries, the MOF, and the ruling Liberal Democratic Party (LDP). This debate set the tone and much of the agenda for the banking-securities conflicts that have taken place since.¹²⁷ In the end, major Securities and Exchange Law and Banking Law revisions in 1981 allowed banks to sell government bonds to the public.

During negotiations involving the 1981 Banking Law and Securities and Exchange Law revisions, the securities industry raised the commercial paper issue with the MOF. The banks opposed commercial paper out of well-grounded fear that commercial paper would further reduce their control of the market for corporate finance. In addition, banks and other interested parties (including the MOF) apparently expected that if commercial paper were to be authorized, it would be through designation as a security,¹²⁸ and that banks would be excluded from the market. This expectation was partially based on the situation in the U.S., the birthplace of article 65, where banks had only recently attempted to enter the commercial paper business and challenge the assumption that commercial paper was a security. In addition, foreign commercial paper had been designated a security under the Foreign Exchange and Foreign Trade Control Law (FECL) of 1979,¹²⁹ which had partially liberalized the movement of capital in and out of Japan.

¹²⁷ The details of this debate are recounted in J. HORNE, *JAPAN'S FINANCIAL MARKETS: CONFLICT AND CONSENSUS IN POLICYMAKING* 98-117 (1985), and F. ROSENBLUTH, *supra* note 28, at 128-36 (1989).

¹²⁸ Commercial paper could have been designated a security either by amendment to the Securities and Exchange Law, by a Cabinet Order as contemplated by Securities and Exchange Law, art. 2, § 1, cl. 9, or by a MOF interpretive decision that commercial paper would be treated as falling within one of the existing categories of securities, most likely as an unsecured corporate debenture.

¹²⁹ Gaikoku Kawase oyobi Gaikoku Boeki Kanri Ho, Law No. 8 of 1960, as amended by Law No. 65 of 1979 (all untranslated Japanese sources are on file with the authors, who have supplied the corresponding references).

In arguing for their position, the banks raised the following policy concerns:

(1) Commercial paper would undermine the traditional rule requiring collateral for Japanese debt financing. Japanese finance was based on the idea that strict collateral requirements would control against losses in the event of default and thereby guarantee the stability of the financial system. Since commercial paper would depart from this principle, introduction without adequate study would endanger investors and raise the potential for chaos in the financial markets.

(2) Commercial paper would weaken the "main bank" system, by which one bank acts as a corporation's principal financial adviser and lender. The "main bank" system had played an important role in Japanese finance, but would be undermined if corporations were to raise funds directly from open money markets.

(3) Commercial paper was a uniquely American product, necessary in the United States because of the absence of interstate banking and because of strict limits on bank loans to individual customers. In Japan, banks had proven able to supply ample short-term finance at low interest rates, eliminating any need for commercial paper.¹³⁰

Others argued that a commercial paper market would reduce the effectiveness of Bank of Japan "window guidance," a leading tool of monetary policy,¹³¹ and would lead to the collapse of the system of regulated interest rates.¹³² The MOF refused to act in the face of bank opposition, citing as its reason the lack of issuer demand for commercial paper given ample availability of bank financing at low, regulated rates of interest.

The securities industry was not satisfied with this result, and it apparently asked members of the governing LDP to introduce an advisory resolution in the national legislature, the Diet.¹³³ The

¹³⁰ See T. AMAYA, *UGOKIDASHITA CP 75-77* (1988) (listing bank arguments). The author of this book is a junior MOF official and served in MOF's Securities Bureau, Capital Markets Section during the period of commercial paper's introduction. The book is representative of MOF views.

¹³¹ "Window guidance" refers to the Bank of Japan setting a specific quantitative ceiling on the aggregate lending of each bank. It is used only during periods of tight money and has the benefit of being a very precise control on the amount of credit in the economy. See Ackley & Ishi, *Fiscal, Monetary and Related Policies*, in *ASIA'S NEW GIANT: HOW THE JAPANESE ECONOMY WORKS* 153, 202-04 (H. Patrick & H. Rosovsky eds. 1976).

¹³² *Daiki-shoki: Komāsharu pēpā*, *Nihon Keizai Shinbun* (Financial Column), May 31, 1985, at 17 [hereinafter *Daiki-shoki*, May 31, 1985].

¹³³ This resolution supported the demands of the securities industry, and yet our

Finance Committee of the House of Representatives passed such an advisory resolution stating that "in order to advance internationalization and the diversification of financial products, the legal and practical aspects of introducing commercial paper should be studied."¹³⁴ The resolution was plainly directed at the MOF, since the commercial paper question was under its banking and securities regulation jurisdiction. This one-sentence advisory resolution is the only evidence of Diet involvement in the decision to introduce commercial paper, and it appears to have had little or no impact on the final decision. The MOF took no action in response to it, having already determined not to act on commercial paper at that time. When the MOF did act after five years, it did so for reasons entirely unrelated to the resolution.¹³⁵

The Ministry's steadfastness in the face of pressure from the legislature is not surprising. While in theory the Diet has great power over the MOF, in practice the relationship between the MOF and the Diet is almost the reverse. The MOF has long been the dominant forum for decisions over financial services. Resort to the Diet usually takes place at the MOF's behest, when a desired policy change cannot be implemented under the existing statutes.

One reason for this custom is that the Diet lacks the staff, expertise, or prestige to pass legislation significantly interfering with the MOF's freedom of action. Japan has a long tradition of the best and brightest students entering the government ministries, particularly the MOF. The MOF recruits heavily from the Law Faculty of the University of Tokyo, and takes the undisputed cream of the crop, the top of the clearly defined Japanese educational

interviews with key participants in the process left us uncertain as to its actual origin. One possibility is that the MOF favored early introduction of commercial paper, but was unable to overcome strong bank opposition. If that were the case, the MOF may have acquiesced in or even indirectly sponsored the Diet resolution. The resolution was vague enough so as not to unduly restrict future MOF action, yet specific enough to provide MOF a basis for later reviving the commercial paper debate with the banks. We believe, however, that the evidence points to a source within the securities industry.

¹³⁴ Japanese Diet, House of Representatives, Finance Committee Advisory Resolution (*Okura iinkai no futai ketsugi*) (May 13, 1981), reprinted in T. AMAYA, *supra* note 130, at 68.

¹³⁵ The question of relations between the Diet and the ministries is an extremely sensitive one. While the MOF officials we interviewed were quite open and forthcoming about relationships within the MOF and with interest groups, they would speak about the Diet in only the most general terms. Of course, this relationship involves the senior MOF officials.

hierarchy. The Diet, in contrast, has few specialists, and its staff consists largely of privately-funded political workers.¹³⁶

Moreover, in Japan's highly regulated system, MOF decisions over the powers and activities of the banking and securities industries are ongoing, since individual firms need the MOF's permission to receive licenses or to undertake numerous transactions. It is in the interests of both the banking and securities industries to keep these decisions in a single forum, so as to ensure even-handedness and predictability. If the MOF were to sacrifice bank interests to the interests of issuers, investors, or securities firms in making one decision, the banks would be in a position to demand assurance of favorable consideration when the next decision arises. As a consequence, the banks and securities firms are able to "bargain" through the MOF, and attempt to find mutually advantageous solutions on a range of issues. The banking and securities industries have extensive experience dealing with the MOF and they recognize it is often in their best interests to accept its decisions. Thus, the MOF can make compromises, and, unlike U.S. administrative agencies, it can enforce those compromises without fear of litigation or effective after-the-fact legislative opposition from either industries within the MOF's jurisdiction or unrepresented interest groups. If the securities firms were to have taken the commercial paper issue to the Diet, not only would they have had no assurance of fair treatment, but they would have had no way of knowing how the Diet would respond, whether other issues would be raised or traded off in response, or whether an unfavorable result could be compensated for in the future. A bidding war for influence in the Diet on a single issue would not have assisted either the banks or securities firms in the process of ongoing regulatory decisions.

Finally, all the participants in the commercial paper struggle—banks, securities firms, and issuers—were constituents of the conservative, business-oriented LDP. The LDP's best strategy was to defer the decision to the MOF, rather than risk a political battle. Moreover, the Diet contains representatives of opposition parties as well as of the LDP. Since the LDP, as the ruling party, is closely allied with the bureaucracy, a shift of resources to the Diet would only serve to empower the opposition parties by bringing them into

¹³⁶ See, e.g., J. HORNE, *supra* note 127, at 193-98 (describing career patterns at the MOF).

the debate, and would diminish the ultimate control exercised by LDP constituencies.¹³⁷

Although the 1981 Diet resolution did not induce the MOF to act, issuer and securities interests made one further effort to move the debate forward. In 1982, the commercial paper issue was taken up in the Industrial Structure Council of the Ministry of International Trade and Industry (MITI).¹³⁸ MITI has authority over the manufacturing industry generally, as well as the trading companies who were expected to (and have in fact) become the largest issuers of commercial paper. It generally represents the concerns of its industrial constituency in interagency debates and could be expected to lobby on their behalf. But bank representatives also sat as members of MITI's Industrial Structure Council, and their strong opposition to commercial paper led the Council to issue a final report citing divided opinion over the commercial paper issue.¹³⁹ This inconclusive result, and the feeling that it would be fruitless to continue discussion without the participation of the MOF given its primary jurisdiction over banking and securities regulation, led MITI to drop the issue.¹⁴⁰ Thus, the first round ended with the MOF refusing to act, and two efforts to circumvent its authority coming to naught.

¹³⁷ For this reason, when the Diet does become involved, the meaningful debate often takes place not in the formal Diet committees, but in the LDP's party committees. The opposition parties have not taken advantage of the apparent opportunities to gain support from consumers of financial services by opposing MOF and LDP positions.

¹³⁸ The Industrial Structure Council is one of the MITI's standing advisory councils, or *shingikai*. These councils provide formal advice to the ministries. Their membership is chosen by the relevant ministry, and generally includes industry representatives, academics, journalists, elder statesmen, and even an occasional consumer advocate. They meet regularly, receive presentations from ministry officials, and are consulted as proposals are prepared.

Shingikai provide a check on agency action, as legislative or regulatory proposals generally do not go forward without the approval of the relevant *shingikai*, and the *shingikai* operate based upon consensus. Perhaps equally important, the *shingikai* legitimize bureaucratic decisions by giving them the imprimatur of a group of respected citizens outside the bureaucracy.

Formal standing *shingikai*, created by statute, advise either individual bureaus or entire ministries. When useful to the bureaucracy, ad hoc *shingikai* have been formed to study particular issues, or to provide viewpoints which the standing *shingikai* do not support. The commercial paper case provides one example of the various *shingikai* in operation.

¹³⁹ See T. AMAYA, *supra* note 130, at 68; *Daiki-Shoki* May 31, 1985, *supra* note 132, at 17.

¹⁴⁰ See Interview with Yoshiaki Koyama, Director, Research Division, Banking Bureau of the MOF, and with other MOF officials in Tokyo (June 24, 1988).

B. *The Changing Landscape: Financial Liberalization
from 1982 to 1985*

After these events, little further formal discussion concerning the introduction of commercial paper took place until early 1986. In this interval, however, the environment in which the commercial paper debate took place changed drastically.

Japan had undergone gradual financial liberalization since the late 1970s, including revisions of the FECL in 1979¹⁴¹ and the Banking Law in 1981,¹⁴² and numerous regulatory changes instituted by the MOF. New financial markets had opened up as regulators and regulated parties alike determined to make Tokyo an international financial center. Banks were allowed to issue negotiable certificates of deposit in 1979; this new market quickly joined the call, bill discount, and *gensaki* markets as one of the principal short-term money markets. The 1981 Banking Law clearly defined bank powers to deal in government bonds, and retail sales of public bonds by banks began in April 1983. The system of regulated interest rates came under pressure from new, market-rate products, as liberalization of foreign exchange rules gave large borrowers and investors a way around the regulated domestic markets, and new domestic products such as money market certificates were introduced.

Liberalization proceeded slowly, however, due to a lack of regulatory momentum. This momentum was soon provided by foreign pressure (referred to in Japanese by the term *gaiatsu*). During 1982 to 1984, the U.S. global trade deficit and the bilateral deficit with Japan reached unprecedented levels.¹⁴³ Part of the blame for U.S. trade performance fell on the strong dollar and weak yen, a phenomenon that might have been explained by high interest rates brought on in part by the U.S. federal government budget deficit, but which some U.S. officials preferred to attribute to closed, regulated Japanese financial markets that depressed demand for the yen and increased demand for the dollar, and even to market manipulation by a mysterious Japanese conspiracy. This supposed link between restricted Japanese financial markets, an

¹⁴¹ See J. HORNE, *supra* note 127, at 153-64.

¹⁴² See *id.* at 107-12.

¹⁴³ See KEIZAI KOHO CENTER, JAPAN INSTITUTE FOR SOCIAL AND ECONOMIC AFFAIRS, "JAPAN 1985: AN INTERNATIONAL COMPARISON" 48 (1985).

overvalued dollar, and poor U.S. trade performance led to U.S. demands for Japanese financial liberalization.¹⁴⁴

Financial liberalization received top priority during President Reagan and Treasury Secretary Regan's visit to Japan in November of 1983. A joint U.S.-Japanese press statement listed eight areas of potential liberalization and announced that MOF and the Treasury Department would establish a Working Group on Yen/Dollar Exchange Rate Issues. The Working Group met during the Spring of 1984, and on May 29, 1984 issued a report detailing a variety of deregulatory measures.¹⁴⁵ One result of this activity was to revive the debate on whether Japan should authorize a domestic commercial paper market.

Although U.S. demands appear to have acted as the catalyst for this chapter of Japanese financial deregulation, the influence of domestic interests favoring deregulation should not be underestimated. These interests welcomed foreign pressure that would help them achieve their goals. Japan has a long tradition of domestic groups using foreign pressure to serve their interests, going back to the time Commodore Perry forced Japan open to the outside world. In the commercial paper case, the large banks and securities firms faced slowly declining benefits from the old system of regulation, and saw great opportunities from deregulation and the emergence of Tokyo as an international financial center. The smaller, less competitive financial institutions and other interests favoring the status quo would have vetoed such change under normal circumstances. By overriding such opposition, the foreign pressure tipped the scales in favor of accelerated liberalization. Once the Yen/Dollar discussions had begun, the MOF quickly prepared a report that covered other liberalization measures, and released it contemporaneously with the Yen/Dollar Report.

During the period up to 1984, one aspect of the debate over financial liberalization which provided an important precedent for domestic commercial paper was the decision to allow sales of foreign commercial paper to investors in Japan. The participation of banks and securities firms in these sales was much discussed. The 1979 revision of the FECL relaxed the regulation of monetary

¹⁴⁴ See, e.g., F. ROSENBLUTH, *supra* note 28, at 50-95 (discussing foreign pressure for liberalization); KINYŪ JIYŪKA TO EN NO KOKUSAIKA 79-95 (Kinyū Zaisei Jijō Kenkyūkai ed. 1985) (recounting events leading up to the establishment of the Yen/Dollar Working Group, and the various proposals put forward by that group).

¹⁴⁵ For a discussion of the Regan visit, see F. ROSENBLUTH, *supra* note 28, at 73-75.

flows in and out of Japan and raised the possibility that, when the proper regulations had been promulgated, Japanese investors could purchase foreign commercial paper and other short-term financial instruments. The revised FECL defined "security" by a list of traditional securities similar to that in the SEL, and, also as in the SEL, allowed for designation of other instruments as securities by Cabinet Order. The MOF used this catch-all provision of the FECL's security definition to designate foreign commercial paper a security for purposes of the FECL. The securities firms asked the MOF to designate similarly foreign commercial paper a security under the SEL, which, pursuant to article 65, would have excluded banks from sales of foreign commercial paper in Japan. But the banks lobbied successfully for equal participation in sales of foreign commercial paper. The MOF completed draft rules for foreign commercial paper sales in 1982.

In the end, introduction of foreign commercial paper was delayed because of bank unhappiness over the plans of securities firms to sell foreign commercial paper that performed as if it were yen-denominated commercial paper, and thereby to hedge exchange risk. Banks saw such a yen-based instrument as direct competition for their large-scale domestic deposits and a threat to their control over short-term money markets. After the U.S. pressure for liberalization increased, the MOF finally arrived at a compromise between the two industries. On April 1, 1984, the foreign commercial paper sales went forward under the 1982 rules, with the exception that securities firms were required to maintain special accounts with authorized foreign exchange banks in order to receive payments.¹⁴⁶ This special account requirement gave banks a share of the business, even if it was unnecessary for providing adequate service or investor protection.¹⁴⁷

One final change between 1981 and 1986 occurred not in Japan but in Europe. France, England, and the Netherlands all responded

¹⁴⁶ See, T. AMAYA, *supra* note 130, at 55-61 (describing details leading up to the opening of sales of foreign commercial paper).

¹⁴⁷ Other decisions regarding bank-securities firm competition were made during this period. In March 1985, MOF negotiated an agreement involving entry into several new areas of business. Banks were allowed to become full dealers of government bonds, and to enter the market for bond futures. Securities firms were allowed to trade CDs, and to intermediate transactions in yen-based bankers acceptances (BA). The banks were said to have gotten the better of this deal. See *CP Dōnyū to Chūkoku F no Shohin Kaizen ga Nihonbashira*, Kinyū Zaisei Jijō, Feb. 10, 1986, at 34-35.

to the growth of Euro-commercial paper markets by establishing domestic commercial paper markets during 1985 and early 1986. These new European markets may have influenced the decision to establish a commercial paper market in Japan in several ways.

First, the banks had argued in 1981 that commercial paper was unsuited to the unique Japanese financial system. Commercial paper could be considered an American aberration, a product made necessary because of the United States' fragmented interstate banking system and used mainly by the United States' proliferating non-bank financial service companies. Domestic Japanese liberalization, with the prospect of further deregulation of interest rates and financial products, had made the Japanese financial system seem less unique by 1986. The rapid growth of Euro-commercial paper and introduction of domestic commercial paper markets in Europe eliminated any argument that commercial paper was an American aberration.

More substantively, the desire that Tokyo become a competitive financial center, and the deep-seated fear of being left behind by western competitors, made the introduction of commercial paper in major European markets an incentive for similar action in Japan. These markets also proved useful models for those in Japan who were considering what shape a Japanese market would take. Writings on the introduction of commercial paper in Japan display keen awareness of the new European markets.¹⁴⁸

C. *The Commercial Paper Debate Resurfaces*

The commercial paper issue resurfaced in early 1986 when *Keidanren*¹⁴⁹ established a Capital Markets Group to study introduction of commercial paper.¹⁵⁰ Banks are represented in *Keidanren*, as they had been in MITI's Industrial Structure Council during that group's 1982 discussion. But the banks did not actively oppose introduction of commercial paper in *Keidanren*.¹⁵¹ Japan's leading financial newspaper, *Nihon Keizai Shinbun*, explained that

¹⁴⁸ See T. AMAYA, *supra* note 130, at 36-43; Y. KAWAMURA, CP=KOMĀSHARU PĒPĀ (CP=Commercial Paper) 113-37 (1987).

¹⁴⁹ *Keidanren* is the Federation of Economic Organizations, roughly analogous to the U.S. Chamber of Commerce but far more influential. It represents Japanese big business on matters of public policy, among other activities.

¹⁵⁰ See Y. KAWAMURA, *supra* note 148, at 160 (noting the establishment of the Capital Markets Group).

¹⁵¹ See CP, *Togin mo Dōnyū Kiun*, *Nihon Keizai Shinbun*, May 28, 1986, at 1 [hereinafter *Nihon Keizai Shinbun*, May 28, 1986].

the Chairmen of Fuji and Sumitomo Banks had been appointed *Keidanren* Vice-Chairmen and, in these positions of responsibility, needed to act impartially and consider the requests of the group as a whole, leaving banking concerns without an advocate. In the end, no banking or securities representatives were included in the Capital Markets Group, so that the group would focus on the needs of issuers instead of the interests of the two industries.¹⁵² Not surprisingly, the result was that the Group recommended early introduction of commercial paper.¹⁵³

By late March 1986 the *Nihon Keizai Shinbun* recognized that the commercial paper question was becoming a hot policy topic. A *Nihon Keizai* financial column came out repeatedly in favor of introducing commercial paper, claiming that three changes since 1981 had made the Japanese financial system a more hospitable environment for commercial paper. First, unsecured debt financing in Japan had become far more widespread than in 1981, with relaxation of MOF regulations on the issue of bonds without collateral. Second, bond rating agencies along the lines of Moody's Investor's Service and Standard & Poor's Corporation had been introduced into Japan, promising to make unsecured corporate debt a less risky, more marketable product. Third, the MOF had continued along a path of gradual deregulation of interest rates, replacing some regulated rates and credit rationing with a market in which commercial paper could be a competitive product.¹⁵⁴

Securities industry representatives suggested that issuer demands for a commercial paper market should be satisfied.¹⁵⁵ In May 1986, the Japan Securities Industry Association announced its own commercial paper proposal. The main features were (1) commercial paper would be introduced; (2) it would be treated as a promissory note rather than a security; (3) underwriting and trading would be limited to securities firms; (4) bank back-up lines would be mandatory; and (5) banks would be used as payment agents.¹⁵⁶ Independent observers criticized the proposal as

¹⁵² See *id.*

¹⁵³ See *id.*

¹⁵⁴ See *Daiki-Shoki: CP no Sōsetsu ga Isoge*, *Nihon Keizai Shinbun*, Mar. 29, 1986, at 15; *Daiki-Shoki: Ki ga Nessuru CP Dōnyū Rongi*, *Nihon Keizai Shinbun*, July 10, 1985, at 17; *Daiki-Shoki: Komāsharu Pēpā*, *Nihon Keizai Shinbun*, May 31, 1985, at 17.

¹⁵⁵ See *Yūzā o Fukumeta Rokujyūgojyōron o Tenkai Shiyō*, *Kinyū Zaisei Jijō*, Feb. 10, 1986, at 30-32 (Interview with Mr. Chino, Chairman, Japan Securities Industry Association).

¹⁵⁶ See *CP Hakkō Tegata Hōshiki*, *Nihon Keizai Shinbun*, May 16, 1986, at 1. The

carving up the market, giving the securities firms the lion's share of the business but requiring mandatory bank back-up lines and using banks as payment agents. In that sense, it provided a nod in the direction of banks, while ignoring the interests of issuers.¹⁵⁷ The securities firms presented their proposal to the MOF and the MOF Securities Bureau's standing advisory council, the Securities Transactions Council. At nearly the same time, the Bond Underwriters Association (another securities industry group) announced a survey of issuers showing widespread support in industrial circles for introduction of commercial paper.¹⁵⁸

These actions by *Keidanren* and the securities industry signaled widespread interest in commercial paper and support for its eventual introduction. *Nihon Keizai Shinbun* hinted that if the banks did not shift their stance on commercial paper, they would lose the chance to influence the details of the commercial paper market and maybe lose the chance to participate in the market, as the securities industry proposal would exclude banks.¹⁵⁹ These developments necessitated some kind of bank response.

The major banks considered the issue again during the summer at the July 1986 City Bank Roundtable (*toshiginkō konwakai*). There was no formal or announced change in bank opposition to commercial paper. Bankers continued to insist on the need for further study of experience abroad with commercial paper. Likewise, they cited recent failure of the newly established market in yen-based bankers' acceptances as evidence that short-term financial markets were not yet mature enough to support a commercial paper market.¹⁶⁰

Nevertheless, bank opposition appeared to weaken. Some banks changed their positions, recognizing that banks' traditional lending to corporate customers had become less profitable as the biggest corporations could gain access to capital markets directly. Within the major banks, those departments interested in expanding their

proposal was a result of a series of meetings of vice presidents of the Big Four securities firms, beginning in March 1986. See *Kokunai CP Ronsō ni Kōshi o Ita "Shōkenshian" no Hamon*, Kinyū Zaisei Jijō, June 2, 1986, at 14.

¹⁵⁷ See *Kokunai CP Ronsō ni Kōshi o Ita "Shōkenshian" no Hamon*, *supra* note 156.

¹⁵⁸ See *CP Dōnyū ni Kigyō wa Sekkyokuteki*, *Nihon Keizai Shinbun*, May 10, 1986, at 13.

¹⁵⁹ See *Nihon Keizai Shinbun*, May 28, 1986, *supra* note 151, at 1.

¹⁶⁰ See *Daiki-Shoki: Konomareru CP Yūzā An*, *Nihon Keizai Shinbun*, Aug. 1, 1986, at 17; *Kokunai CP: Shichigatsu Reikai made ni "Kangaekata" o Sakusei*, Kinyū Zaisei Jijō, July 7, 1986, at 32 [hereinafter Kinyū Zaisei Jijō, July 7, 1986].

securities activities began to look upon commercial paper as a possible business opportunity. This was partially a result of the record profits Japanese securities firms were making at the time, and of the growth of the Tokyo securities markets. But Japanese bankers also were acutely aware of the Bankers' Trust litigation in the United States,¹⁶¹ which was reported regularly in the Japanese financial press, as well as of the intense lobbying in the United States for abolition of Glass-Steagall. There were at least some reports that the efforts of U.S. banks to enter the commercial paper market led Japanese banks to see commercial paper as a new business opportunity.¹⁶²

Now the banks' first priority was not to foreclose a commercial paper market entirely but to "stop the rogue securities industry proposal."¹⁶³ Bank opposition did not formally end until after the internal MOF compromise of February 1987 described below,¹⁶⁴ but, according to the financial press, there was a private memorandum circulated among the major banks at the July 1986 City Bank Roundtable detailing reasons for a shift toward a neutral position.¹⁶⁵ Finance Ministry and Bank of Japan (BOJ) officials told us that bankers presented them with widely diverse views on the question.

There was also significant official support for creation of a commercial paper market; the BOJ began to champion this position and it issued an official report to that effect in January 1987.¹⁶⁶ The BOJ shift from neutrality toward active support was partially motivated by new CP markets in Europe. BOJ officials expressed the concern that if commercial paper was not introduced within the domestic Japanese financial markets, financial transactions would simply move overseas.¹⁶⁷

¹⁶¹ See, e.g., *Bankāzu no CP Gyōmu ni Gohō Hanketsu*, Kinyū Zaisei Jijō, Jan. 19, 1987, at 72-73 (reporting the decision in *Bankers Trust II*, discussed *supra* note 77 and accompanying text).

¹⁶² See *CP wa Tegata Atsukai: Nichigin, Kokunai Dōnyū e Kenkai*, Nihon Keizai Shinbun, Jan. 21, 1987, at 11 [hereinafter *Nihon Keizai Shinbun*, Jan. 21, 1987] (claiming U.S. banks' stance to be the source of scattered Japanese bank support for commercial paper).

¹⁶³ Kinyū Zaisei Jijō, July 7, 1986, *supra* note 160, at 32.

¹⁶⁴ See *infra* text following note 166.

¹⁶⁵ See *Kokunai CP Shijō "Kokkakuzū" no Kōzaihaibo*, Kinyū Zaisei Jijō, May 4, 1987, at 38.

¹⁶⁶ See Kosugi & Dickinson, *The Creation of a Domestic Commercial Paper Market in Japan*, 27 COLUM. J. TRANSNAT'L L. 91, 109 (1988) (citing TANKI SHIJŌ, THE SHORT-TERM FINANCIAL MARKET 288 (Nihon Keizai Shimbunsha ed. 1987)).

¹⁶⁷ See *Nihon Keizai Shinbun*, Jan. 21, 1987, *supra* note 162, at 11. Officials at the

D. *The Ministry of Finance Decision*

Against the background of this private sector and official activity, the commercial paper question came under official scrutiny for the second time in 1986. With powerful forces favoring the creation of a commercial paper market and the bank opposition weakening, MOF officials were now more amenable to the idea than they had been in 1981. But they faced a practical problem in developing a procedure for deciding the issue. Under ordinary circumstances, administrative decision-making in Japan follows well-defined channels, with each ministry within the government and each bureau within each ministry having clearly defined areas of jurisdiction. It was respect for this clear division of jurisdiction that made MITI, the BOJ, and even the Diet reluctant to force the issue in the early 1980s when the MOF decided not to take action. The problem now lay within the Ministry. Two of its most important bureaus are the Banking Bureau and the Securities Bureau, and the commercial paper issue fell between them. Moreover, the fact that it fell between them was not simply an accident of administrative organization, to be resolved by a mixture of decisive action and feather smoothing; rather, it was the very essence of the conflict. To assign the task of creating a commercial paper market to the Banking or Securities Bureau would have effectively decided the question at issue: is commercial paper a banking function or a security?

The internal structure of the Japanese bureaucracy served to heighten the conflict. Japanese officials, who have the most prestigious educational credentials in the nation, are appointed to a ministry for their entire careers in government, and their professional success depends upon their effectiveness in their assigned positions. Although they are rotated from one bureau to another every two or three years to avoid developing ingrained attitudes, they devote their intelligence and energy, as well as sixty to eighty hours of work per week, to their position at the time, and

BOJ suggested that their report, prepared in late 1986, had been leaked to the press. As an influential institution and one responsible in part for regulating the banking sector, BOJ's support for commercial paper could easily have had an impact on the banks' position. Further, the BOJ report was the first official, governmental support for commercial paper.

The major features of the BOJ proposal were that commercial paper be considered a note rather than a security, that credit rating agencies rate the commercial paper, and that back-up credit lines be required.

often measure their success by their ability to take charge of problems and develop new statutory or administrative solutions. In addition, each bureau has extensive contacts with members of the industry it regulates and tends to serve as an advocate for its interests, as well as a regulator of its activities.¹⁶⁸ Thus, a conflict between two major bureaus within the Ministry was not something that either insiders or outside interest groups would take lightly.

The MOF's solution, not surprisingly, was to have the chiefs of the two relevant Bureaus, Mr. Hirasawa of Banking and Mr. Kitayama of Securities, meet together in late 1986 or early 1987 to agree upon a decision-making procedure. The precise nature of this procedure, and the exact chronology of events, are lost within the misty confines of the MOF. Hirasawa and Kitayama did not sit in the same room and discuss the details of the proposal; they were too senior to do so and the potential for direct conflict would have been too great. Rather, they assigned the task to their immediate subordinates—for the Banking Bureau, Mr. Nakahira of the Banking (i.e. big banks) Section and, for the Securities Bureau, Mr. Uchida of the Capital Markets Section. Nakahira and Uchida, however, were also too senior to meet together. They assigned their assistants to deal with the issue and it was apparently at this level that the bureau-to-bureau contacts within the Ministry occurred.

These contacts proceeded during January and February of 1987 under the direction of Nakahira and Uchida, the two section chiefs. Our information suggests that Uchida was probably the guiding force. In hammering out a compromise, the officials consulted extensively with their industry contacts, generally on an *ex parte* basis. They were motivated by a desire to find a solution that was acceptable to both industries, so that the final decision would rest with the MOF, and neither side would appeal to the Diet for new legislation, as the securities industry had apparently done in 1981. In addition, they wanted to have an agreement on their records before June 1987, when many of them would be rotated to new positions. This was particularly important to the officials in the Banking Section, who had not undertaken any major initiatives during the previous years.

The negotiations proceeded quickly, and the MOF informally indicated that it had decided on a proposal in February 1987.¹⁶⁹

¹⁶⁸ See F. ROSENBLUTH, *supra* note 28, at 19-20 (discussing the prestige that attaches to a position in the Japanese bureaucracy).

¹⁶⁹ For accounts of the progress of the negotiations, see, e.g., *CP Rūru Sakusei*

This decision, as one might expect, represented a compromise between banking and securities interests.

First, as had been suggested in both the securities industry and Bank of Japan proposals, commercial paper would be introduced as a promissory note and not a security. This would enable the market to go forward immediately, without involvement of the Diet to create a new legal form. The promissory note approach allowed both banks and securities firms to participate in the market, an essential element to a successful compromise. It also allowed more favorable tax treatment for commercial paper than for securities under existing laws, as a graduated stamp tax would be levied instead of a securities transaction tax. The alternative—treatment as a type of corporate bond or debenture under Japanese law—was unacceptable. Bank participation would have been foreclosed, onerous disclosure requirements would have applied, and the Corporations Law¹⁷⁰ would have required board of directors approval before each issuance of commercial paper.

Second, “direct paper” (commercial paper sold directly from issuer to investor) would not be allowed. Only “dealer paper” (commercial paper underwritten by a bank or securities firm) would be accepted. This was described to us as allowing banks to maintain an advantage over non-bank competitors at raising funds, considered an important point by the MOF until the terms of bank competition with non-bank financial services companies are resolved. In fact, since non-bank finance companies were not permitted to issue commercial paper, this explanation seems inadequate. Prohibiting direct paper obviously favors the banks and securities firms, and may have been part of the effort to protect banks and alleviate bank opposition. It also is in the interests of the MOF, since the MOF has little regulatory authority over issuers, and could not easily control a market where issuers dealt directly with

Ōzume, *Nihon Keizai Shinbun*, Apr. 7, 1987, at 5 (reporting that there would be 180 eligible issuers, and that back-up lines would probably be required for most issuers); *CP Hakkō kigyō 100-sha Zengo: Rūru Katamaru*, *Nihon Keizai Shinbun*, Mar. 19, 1987, at 3 (reporting that only dealer paper would be permitted, predicting that only 100 corporations would meet the requirements for issuance, and noting that the MOF planned to complete product design by June and open the market by the end of 1987).

¹⁷⁰ See SHŌHŌ, art. 296. For a discussion of this provision of Japanese corporate law, see Yoshikawa & Harada, *Kokunai CP Shijō Sōsetsu ni Tsuite*, *Kinyū Zaisei Jijō*, Nov. 23, 1987, at 34, 35.

investors. Only issuers and investors, under-represented in the MOF decision-making process, have reason to favor direct paper.

After the February agreement, the Banking and Securities Bureaus began to work together on the other elements of the commercial paper market. The major decisions were made over the next few months with further *ex parte* contacts between the MOF and the two leading industry groups. Other groups were not fully aware of the progress of events until the February announcement, and needed quickly to organize their position. The large trading companies, which have turned out to be the most active issuers of commercial paper, established a commercial paper working group, and by the end of March, had submitted a very liberal proposal to the MOF.¹⁷¹

Another element in the MOF's decision-making process was the meetings of the Commercial Paper Advisory Group. Virtually every bureau of every Japanese Ministry has a standing advisory council (*shingikai*) that meets to consider proposed changes in that bureau's regulatory activities. The precise role of these advisory councils is a matter of debate among people we interviewed; the advisory councils may be important sources of new ideas, or provide guidance and information for the officials who make the decisions, or help these officials obtain assent to decisions the officials alone have made, or serve a purely decorative function. Whatever their role, the MOF's standing advisory councils were of limited value in the commercial paper decision, since each related to a single bureau. These relations significantly constrained their advisory functions. The Securities Transactions Council of the Securities Bureau had issued a report in 1986 that vaguely proposed further study, but lacked a clear recommendation.¹⁷² The Financial System Research Council of the Banking Bureau had not issued any report at all. Thus, when the joint Banking-Securities process was initiated, the MOF decided to create the Commercial Paper Advisory Group, an ad hoc council selected from those members of the two advisory councils who lacked any direct stake in the banking or securities industries. The members and their positions were as follows:¹⁷³

¹⁷¹ See *Kokunai CP An wa Riyōsha no Shiten o Kaite Iru*, Kinyū Zaisei Jijō, May 25, 1987, at 35 (interview with official of Mitsui & Co.); *Shōsha ga Kokunai CP Hakkō ni Tsuite no Yōbōshō o Teishutsu*, Kinyū Zaisei Jijō, Apr. 20, 1987, at 9.

¹⁷² See Shokentorihiki Shingikai, *Shasai Hakkō Shijō no Arikata ni Tsuite* (Dec. 12, 1986), reprinted in T. AMAYA, *supra* note 130, at 85-86.

¹⁷³ See T. AMAYA, *supra* note 130, at 89.

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Takuhiko Tsuruta	Executive Vice President, Nihon Keizai Shinbun, Inc.
Tetsuro Nishizaki	President, International Management Consultants, Ltd.
Yo Maeda	Professor, Gakushuin University
Shinichi Royama	Professor, Osaka University
Mikio Wakatsuki	Director General, General Affairs Bureau, Bank of Japan

This ad hoc Advisory Group met only twice, once on April 23, 1987 and again on May 14.¹⁷⁴ At the second meeting, it approved the MOF proposal in its entirety. The limited number of meetings and the absence of proposed amendments or lengthy debate gave the ad hoc group the appearance of a rubber stamp. It is commonly said that in Japan formal debate (such as presentation to an advisory council) often follows most of the actual negotiation; this certainly appears to have been the case with the Advisory Group. Its role was apparently to add legitimacy to the MOF decision. Particularly in light of trading company complaints that the proposal favored the interests of banks and securities firms, it was important that a neutral group lacking banking or securities representatives approve the result. The appearance of neutrality was important for the MOF to maintain its ability to negotiate enforceable compromises, and to discourage the regulated industries from seeking help in the Diet or some other forum.

This explanation of the Advisory Group's role may be a bit too simple, however. The officials who negotiated the compromise among themselves knew they would need to obtain the assent of the industry groups. Moreover, the terms of the discussion in the Advisory Group may have served as an intellectual framework for the officials' analysis of the issue. There has been an ongoing debate among Japanese law professors about corporate finance, with the theoretical school maintaining that the law should place all corporate debt and equities in strict categories, and the pragmatic school maintaining that the law should follow business practices.¹⁷⁵ Professor Akio Takeuchi, of the University of Tokyo Law Faculty, was the leader of the pragmatic school, and many of the MOF officials, being graduates of that school, had studied under

¹⁷⁴ See *Ōkurashō, CP Kondankai de Shohin Genan o Teiji*, Kinyū Zaisei Jijō, May 4, 1987, at 31.

¹⁷⁵ See Interview with Professor Takeuchi (June 28, 1988).

him. Takeuchi was a member of the Advisory Group, and the discussion in the Advisory Group focused on the merits of the pragmatic approach. These discussions, therefore, may have reflected the discussions among MOF officials rather more than the temporal order of the two would suggest.

Six days after the Commercial Paper Advisory Group approved the MOF proposal, the standing advisory councils of the Banking and Securities Bureaus also approved the proposal. The details of issuing, transferring and redeeming commercial paper were worked out between May and October, and uniform dealer contracts and commercial paper certificates were developed. On November 2, 1987, the two Bureaus issued nearly identical notifications to their respective industries, explaining the MOF's requirements for issuing, underwriting, and trading commercial paper.¹⁷⁶ These notifications provide the only basis for the commercial paper market. They are not based on any explicit statutory directive, and have no binding legal effect.¹⁷⁷

No one was wildly enthusiastic about the final result. Potential issuers of commercial paper were disappointed by the MOF's various restrictions, including a minimum one month maturity date and a restriction on the number of issuers, as well as the prohibition on direct paper already discussed. They saw these restrictions as efforts to keep the commercial paper market from replacing too much of the banks' short term lending business, just as they saw the prohibition on direct paper as an effort to include banks in whatever commercial paper market did develop. They also objected to the Ministry's graduated stamp tax, amounting to 0.24% of the face value for a one billion yen issue with a one month maturity rolled over for one year.¹⁷⁸ They noted that this tax put commercial paper at a disadvantage vis-à-vis bank lending, to which no such tax applies. No stamp tax, minimum maturity, issuer restriction, or

¹⁷⁶ See Ministry of Finance, Banking Bureau, Notification No. 2825, Nov. 2, 1987, *trans. in* Kosugi & Dickinson, *supra* note 166, at 133-34; Ministry of Finance, Securities Bureau, Notification No. 1830, Nov. 2, 1987, *reprinted in* *Kinyū Zaisei Jijō*, Nov. 9, 1987, at 72-73 and *Kinyū Hōmu Jijō*, Nov. 25, 1987, at 37-38 (also reprinting various other documents of interest to market participants).

¹⁷⁷ The MOF has ample discretionary powers over the banking and securities industries to enforce such compromises. It does not, however, have such powers over non-financial corporations. As Kosugi and Dickinson remark, this lack of MOF control over issuers is one reason that direct paper is prohibited. See Kosugi & Dickinson, *supra* note 166, at 115.

¹⁷⁸ See *id.* at 113.

back-up line requirements exist in the U.S. commercial paper market.

Securities firms also expressed dissatisfaction with the MOF proposal. They felt that bank participation had been accepted for purely political reasons, without any discussion of the policies behind article 65, or the potential for conflicts if the same bank underwrites commercial paper, provides the back-up line, and ends up holding unsalable paper.¹⁷⁹ Securities firms also worried that the bank monopoly on back-up lines and payment agency business would allow banks to gain advantage in the marketplace.

Meanwhile, the banks had lost out in their effort to prevent a commercial paper market from being established. Their proposal that the market be limited to fewer than one hundred corporations had also been rejected, and instead nearly twice that number would be eligible to participate from the beginning. Banks felt that short-term finance was properly their monopoly, and saw commercial paper as an invasion of their turf by the securities industry.

MOF officials considered this result—some dissatisfaction on all sides, but with all parties willing to acquiesce in the proposal—the best that could realistically be expected. In fact, all parties we met with saw this dissatisfaction as evidence that a fair compromise had been reached.

One additional detail of the MOF proposal also helped to alleviate the mild dissatisfaction all parties felt. The proposal stated that the structure of the commercial paper market would be reviewed after one year of operation. Those who felt the market was too restrictive realized that, as in other newly liberalized areas of Japanese finance, the review would probably result in a relaxation of requirements. On the other hand, the banks knew that if commercial paper caused serious trouble for short-term bank lending or bank profitability, they would have an opportunity to present their case to the MOF.

E. *The Commercial Paper Market In Practice*

The Japanese domestic commercial paper market opened on November 20, 1987, exactly six months after approval of the MOF's proposal by the two standing advisory councils.¹⁸⁰ On its first day

¹⁷⁹ See *Ginkō ni Yoru Kokunai CP no Jikohoyū ni Mondai wa Nai ka*, Kinyū Zaisei Jijō, July 27, 1987, at 17.

¹⁸⁰ See Yoshikawa & Harada, *supra* note 170, at 35.

of operation 800 billion yen (\$6 billion) of commercial paper was issued.¹⁸¹ The market grew at a steady pace with the amount of commercial paper outstanding reaching 4 trillion yen (\$30 billion) by the end of April 1988. By the end of August 1988, it had reached 5.641 trillion yen (\$42 billion), surpassing the bill discount market in size,¹⁸² and following the one-year review's relaxation of requirements, it grew to over 10 trillion yen (\$75 billion).¹⁸³

Banks and securities firms were initially willing to underwrite commercial paper at unsustainably low rates, well below the margins required for profitable dealing. Although rates increased gradually throughout 1988, approaching the rate for CDs, commercial paper distribution remained unprofitable. Underwriters purchased and distributed commercial paper only as a way to ensure a share of the issuer's other business, deeming commercial paper "charity paper" or "connection paper."¹⁸⁴ Participants reported to us that issuers engaged extensively in arbitrage: they would issue commercial paper and then place the funds obtained from the issues into higher yield bank time deposit accounts or Cds. Such arbitrage was estimated to account for the lion's share of commercial paper, up to eighty or ninety percent, at least until the interest rates paid by commercial paper issuers began to increase in the summer of 1988.¹⁸⁵ The largest purchasers of commercial paper were investment trusts, followed by the smaller regional and mutual banks, which found that commercial paper gave a higher yield on their funds than the call market.¹⁸⁶

¹⁸¹ See *id.*

¹⁸² See *Rēto Jōshō de Kugatsumatsu wa Genshō*, *Nikkei Kinyū Shinbun* (The Nikkei Financial Daily), Sept. 19, 1988, at 1.

¹⁸³ See *CP-ope Raishū ni mo Jisshi*, *Nihon Keizai Shinbun*, May 16, 1989, at 1.

¹⁸⁴ See *Japan Commercial-Paper Market Grows Although Critics of System Abound*, *Wall St. J.*, Oct. 31, 1988, at C23, col 1.

¹⁸⁵ This was revealed through conversations with securities and banking industry participants in June 1988. The arbitrage was widely reported in the financial press. See, e.g., *Nikkei Kinyū Shinbun*, May 3, 1988, at 1 (noting that issuers were taking advantage of "blood letting" rates and placed proceeds of issuance in large-scale time deposit accounts); see *Nikkei Kinyū Shinbun*, June 29, 1988 (reporting that the gap narrowed between commercial paper rates and the effective interest rate on bank borrowings, and predicting an end to arbitrage issuance). Although margins have narrowed, arbitrage issuance continued to dominate the market into 1990. The amount of funds in large-scale time deposits at any time is closely correlated with the amount of commercial paper outstanding, evidencing this widespread arbitrage.

¹⁸⁶ See *Kokunai CP Shijō ni Kekkan, Da ga Ni-Chō En ni*, *Nihon Kinyū Shinbun*, Feb. 19, 1988.

The market in commercial paper sold under repurchase agreements (*gensaki* commercial paper) grew even faster than the underlying commercial paper market, and proved a welcome supplement to the existing *gensaki* market in government bonds. For the month of August 1988, total *gensaki* commercial paper transactions totalled over 50 trillion yen (\$375 billion).¹⁸⁷

During the first few months of operation, banks and securities firms underwrote commercial paper in relatively equal shares. As time progressed, however, the banks' share of commercial paper underwriting business increased to around seventy percent, leaving securities firms the remaining thirty percent.¹⁸⁸ In September 1988, the Bank of Japan announced that it would begin open market operations in commercial paper to increase its control over short-term financial markets and interest rates.¹⁸⁹

The commercial paper market appeared to be a success with its growth exceeding most expectations. MOF officials expressed general satisfaction with the development of the market and no awareness of any great problems. The banks were pleased that commercial paper had not cut into their basic businesses as much as might have been feared, and that they had won a large share of the commercial paper market. The securities firms, however, were less happy with the development of the market. They claimed that the banks' large market share was based not on the merits of competition, but on regulatory advantages. Market observers and participants expressed concern with the widespread existence of arbitrage and the apparent failure of corporations to use the market to meet their actual needs for short-term funds. The heavy stamp tax, along with the small number of eligible issuers, limited the commercial paper market's potential.¹⁹⁰ Further, the market was closed to finance companies and securities firms, the non-bank commercial paper issuers who dominate the market in the United States.¹⁹¹

¹⁸⁷ See *CP Ryūtsū Shijō ga Kyūkakudai*, Nihon Keizai Shinbun, Sept. 17, 1988, at 7.

¹⁸⁸ This statistic was provided by MOF officials, and confirmed by market participants.

¹⁸⁹ See *Japanese Money Markets: Coming Home*, *ECONOMIST*, Nov. 19, 1988, at 93 [hereinafter *Japanese Money Markets*]; *Ōpun Shijō Arata na Chōsetsu Shudan*, Nihon Keizai Shinbun, Sept. 15, 1988, at 11.

¹⁹⁰ See *Wall St. J.*, Oct. 31, 1988, at C23, col. 1.

¹⁹¹ For a general discussion, see *Guidelines for Domestic CP and Its Revision*, ZENGINKYO FIN. REV. No. 4 (1989).

As promised in the MOF commercial paper proposal, the market was reviewed in November 1988, after one year of operation, and, as before, the decision-making process was confined to the MOF, and involved extensive discussions with industry representatives. The securities firms and trading companies took similar aggressive positions in favor of market liberalization. The securities firms proposed that the requirements for qualification as an issuer be relaxed, with the implementation of a rating system for commercial paper, and any commercial paper issue allowed that received one of the two highest ratings. Issues would not be limited to corporations listed on the Tokyo Stock Exchange, but would be permitted for other corporations which provide continuing disclosure. A subsidiary corporation not meeting the requirements for issue would be allowed to issue based upon a guarantee by its parent corporation or a financial institution. Most importantly, securities firms and finance companies would be allowed to issue commercial paper.¹⁹² The trading companies' proposal, presented through a trade association, differed little.¹⁹³

Under both proposals, the stamp tax would be fixed at 200 yen per certificate, as with yen-based bankers' acceptances, the minimum maturity of one month would be dropped, and the maximum maturity would be expanded from six months to one year. Back-up lines would be optional for all commercial paper issues receiving the highest rating. The minimum denomination would decrease along with that of the CD, recently relaxed from 100 million to 30 million yen.

The banks opposed nearly all the suggested changes. They took a passive or neutral position on implementing a rating system. They found no need to increase the number of eligible issuers, as this would reduce bank lending; and they found no need to expand the scope of permitted maturities, as the greatest issuer demand appeared to be for three month paper.¹⁹⁴

The banks' strongest opposition was focused on proposed changes in the basic structure of the market. If securities firms and non-bank finance companies were allowed to issue commercial

¹⁹² This was revealed through discussions with Nomura Securities personnel, June 1988, and review of their preliminary draft of proposal for the one-year review. See (*Shokenkai Kara no*) CP no Minaoshi ni Tsuite no Yōbōjiko (An), May 1988 (Securities Industry Draft Proposal for One-Year Review of the CP Market).

¹⁹³ See *Nonbanku CP ni Hantai*, Nikkei Kinyū Shinbun, Sep. 29, 1988, at 1.

¹⁹⁴ See *id.*

paper, that commercial paper would resemble and compete with the banks' negotiable CDs. The banks argued that issues based on the guarantee of a parent company should be prevented in order to maintain confidence in a stable, orderly financial system. Issue of direct as well as dealer paper would be "premature," from the standpoint of market confidence and investor protection.¹⁹⁵

The result of the one-year review was announced in November 1988. The MOF sided largely with the banks on the most fundamental issues, and reserved for further study proposals for any changes in the basic structure of the market. On proposals for expanding the scale of the market, the MOF compromised. A rating system was introduced, and standards for issuance were relaxed so that approximately 450 corporations would qualify. The number of issuers without mandatory back-up lines was likewise increased, and the MOF stated plans to limit back-up lines to some portion of issued commercial paper. The minimum maturity was shortened from one month to two weeks, and the maximum was lengthened from six to nine months. Otherwise, the market was to continue in operation as before.¹⁹⁶ These changes accompanied the Bank of Japan's liberalization of the short-term interbank money markets, including BOJ trading in commercial paper.¹⁹⁷ The BOJ began trading commercial paper, shortened maturities in the bill discount market from one month, and announced plans to trade one-week and three-week bills for its own open market operations. The longest maturity of the call market was expanded from three weeks to six months.¹⁹⁸

The gradual approach that MOF adopted toward regulatory change held three advantages from the Ministry's perspective. First, it eased the impact of the changes on the affected institutions, thereby allowing them to adjust. This was a benefit in itself and also made it easier to pursue regulatory change in the future. The result

¹⁹⁵ See *id.*

¹⁹⁶ See *Yen Commercial-Paper Market: Chinked Armour*, ECONOMIST, Dec. 10, 1988, at 91-92. A second review of the CP market was completed on February 15, 1990. The number of eligible issuers again increased, to 530 firms. More importantly, beginning in October of 1990, no bank back-up line will be required if acceptable to a rating agency. Also, a tax law revision effective April 1, 1990, drastically reduced the stamp tax burden on CP. The tax on a 100 million yen CP certificate decreased from ¥40,000 to ¥5,000. See *CP Shijō no Genjō Rūru Minaoshi ni Tsuite*, Kōshasai Geppō, Feb. 4, 1990, at 15-27; *Kokunai CP Saiminaoshi no Inpakuto*, Kinyū Zaisei Jijō, Feb. 2, 1990, at 16-23.

¹⁹⁷ See *Japanese Money Markets*, *supra* note 189, at 93.

¹⁹⁸ See *id.*

of this lessening was that the ferocity of opposition from the beneficiaries of regulation was reduced. As a general matter, the institutions that rely on protected market niches may grudgingly accept gradual change although they would fight desperately to avoid the overnight destruction of their niche.

Second, the gradual approach also gave the MOF time to assess the impact of a regulatory change on the financial system. This in turn permitted the MOF to achieve its prime regulatory goal of maintaining the stability of the financial system. A gradual approach by regulators eases worries of financial chaos and collapse when major changes, such as the deregulation of interest rates, introduction of unsecured corporate bonds, or establishment of a commercial paper market, take place.

Finally, the gradual approach resulted in a steady stream of MOF decisions, and thus made regulatory policy-making an ongoing process. This added to the MOF's power over the regulated industries and made resort to the Diet as protection from the MOF less practical. Even if an interest group could persuade the Diet to make a satisfactory initial decision, the MOF could later change the details. For the regulated industries, maintenance of a good relationship with the MOF remained the preferred approach.¹⁹⁹

IV. ANALYSIS

Having described the events in Japan and the United States, we turn now to a comparison of the two case histories and, in particular, to the process of administrative decision-making in these two large, highly industrialized nations. The comparison is facilitated by the similarity between the two nations, not only in the statutory scheme, but also in the underlying market forces.

In both nations, commercial paper represented a threat to the core bank business of providing short term credit to large business enterprises. To be sure, in Japan the commercial banks so dominated the short-term credit business that there was no commercial paper market at all prior to 1987,²⁰⁰ whereas in the United States

¹⁹⁹ The gradual approach contrasts with London's "Big Bang" of October 1986, when, following a major legislative revision, British regulatory authorities deregulated and reorganized the London securities markets in one massive event. *See, e.g.,* Marshall, *The Big Bang Rocks London*, L.A. Times, Oct. 27, 1986, §4, at 1, col. 2 (noting, "collectively, the changes [associated with the Big Bang] are the most sweeping ever undertaken by any major financial center").

²⁰⁰ *See supra* text accompanying notes 126-30.

a commercial paper market had always existed, although its dimensions were relatively modest until fairly recently.²⁰¹ This meant that in Japan banks were in the position of guarding a rent as to which they had a near-monopoly, whereas in the United States banks were attempting to recover a rent which had been partially appropriated by the securities industry. Thus, in Japan, banks were in the conservative posture of resisting change, while in the United States they assumed the role of agitators for reform. These different roles, however, should not obscure the underlying reality that in both countries banks were resisting inroads into their core businesses of providing short-term business credit.

In both countries the fight over commercial paper was merely one part—although a central part—of a broader set of dynamic developments in politics and financial markets. Advances in information and communications technology meant that sophisticated institutional investors could evaluate the creditworthiness of major industrial corporations without the need to rely on the expertise of a commercial bank or other financial intermediary. These technological and market developments greatly increased the degree to which commercial paper could displace commercial bank loans as a source of short term credit to industry. More generally, as the efficiency of direct investments increased, banks became interested in entering the securities business in a variety of ways, of which commercial paper was only the most important initial product.²⁰²

In both countries the commercial paper decision was influenced by the globalization of financial markets. In the case of Japan, the decision to establish a commercial paper market was partly a response to pressure from the United States and other western governments. These governments believed that the lack of short term credit markets in Japan impeded the growth of the yen as a truly international currency. The Japanese were also acutely aware of developments in the American and European commercial paper markets.²⁰³ Events in the United States were not influenced by these sorts of international considerations; nevertheless, the argument for American bank entry into the securities business was greatly strengthened by the fact that the largest American banks were already underwriting securities in overseas markets to which

²⁰¹ See *supra* notes 13-24 and accompanying text.

²⁰² See *supra* notes 10 & 14-27 and accompanying text.

²⁰³ See *supra* notes 143-48 & 161 and accompanying text.

the provisions of the Glass-Steagall Act do not extend. It was also significant that American banks were competing in a global marketplace which included powerful European banks with broad securities underwriting powers. Thus, although the globalization of world financial markets affected the United States and Japan differently, the general fact remains that events in both countries were deeply influenced by developments in world financial markets.

Given these similarities of underlying market forces and economic consequences, we can trace the similarities and differences in the American and Japanese decision-making process. At the outset, any hypothesis about a higher level of consensus in Japanese society must be rejected. In both countries, consideration of the issue was accompanied by intense interest group lobbying, with the big banks squaring off against the big securities firms. Although the conflict was more public in the United States, it was no less intense in Japan, notwithstanding the fact that it was played out in a private rather than public arena. Measuring the strength of interest group pressures is difficult, but the ferocity of the conflict in Japan was remarkable and may actually have exceeded the intensity of the American struggle.

A. *The Preclearance-Postclearance Distinction*

While the level of conflict was equally great, the means by which the conflict was expressed and resolved in America and Japan were distinctly different. We believe that the most important underlying difference between the two histories can be captured in the distinction between what we call "preclearance" and "postclearance" methods of conflict resolution. The event of "clearance" may be identified as a generally-announced decision by the decision-maker who is officially assigned to resolve the issue. Within a corporation, this decision-maker might be the officer assigned to a particular area of operations, and the general announcement might be a business report to the CEO. In the government, the decision-maker will often be the administrative agency that has primary jurisdiction of the area, and the announcement will be the first official decision.

As is apparent, clearance is a relative concept. If one identifies the firm in its entirety as the decision-maker, rather than one of its officers, and its first statement to the public or to the government as the announcement, rather than a report to that officer, the amount of conflict resolved at the preclearance and postclearance stages will be different. Similarly, one might regard subdivisions of

the responsible administrative agency as the decision-makers, and statements to the agency head as the announcement; this again would affect the distribution of events between the stages. The reason is that clearance, as we use the term, is not a real-world event. It is not a concept consciously available to the actors. Rather, it is an interpretation, a means of understanding patterns of decision-making and comparing them to one another. Its value, therefore, is not derived from the precision with which it can be located, but rather from its usefulness for understanding the process in question.

One useful hypothesis that might be derived from the concept of clearance, when it is applied to a given institution, is that the level of preclearance conflict resolution increases as the event of clearance is set higher in the institution's hierarchy. For example, in a corporation, more conflicts will be resolved before a statement is made to the public by the corporation's CEO than are resolved before a statement is made to the CEO by the chiefs of corporate sub-units. If empirical data indicate that this hypothesis is valid, it would suggest that the concept of clearance is a useful one for understanding institutional decision-making.

We believe that the concept of clearance is useful for making cross-cultural comparisons between analogous decisions. Specifically, it is our hypothesis that when the event of clearance is set at equivalent levels of government, Japanese government officials resolve more conflicts at the preclearance stage than American officials. The question of equivalence is a complex one, of course, often beset by all the difficulties of cross-cultural comparison. In our case study, however, the answer to this question is facilitated by the similarity of the issue in both nations, and the consequent ease in identifying equivalent government decision-makers.

The U.S. government decision-maker that was initially assigned to resolve the commercial paper issue was the Federal Reserve Board. The Board's jurisdiction derives from direct statutory authorization. In Japan, the decision-maker was the Ministry of Finance, which possesses comprehensive jurisdiction over all activities by financial institutions. Clearance occurred when each agency announced its interpretation of the governing statute regarding the ability of commercial banks to deal in commercial paper.

Interestingly, the decisions that constituted clearance in each case were essentially equivalent. In 1980, the Fed declared that commercial paper was not a security for purposes of the Glass-

Steagall Act and that banks could therefore buy and sell it for their own account. Because of the potential hazards, however, the Board imposed a number of restrictions aimed at insuring that the paper was high quality, and that it was sold to sophisticated investors, not to the general public.²⁰⁴ The MOF's decision, announced in May 1987, and officially promulgated in November of that year, was also that commercial paper was not a security, and that banks could therefore participate in the newly-created market. The MOF also imposed restrictions, the principal ones being limited issuer eligibility and mandatory bank back-up lines to ensure the quality of commercial paper issues.²⁰⁵

In both cases, therefore, the agency adopted a similar approach, ostensibly as its best interpretation of the statute, but also as a way of going forward with deregulation, while avoiding statutory language that could only be changed by legislative action.²⁰⁶ Moreover, restrictions were imposed in both cases that were ostensibly designed to decrease risk, but also intended to satisfy conflicting interest groups, while retaining the agency's control over the market.²⁰⁷

There was, however, a dramatic difference between the two decisions, despite their substantive similarity. The Federal Reserve decision was simply the first stage in an extended decision-making process that involved two levels of judicial authorities, a subsequent decision by the Fed, and a variety of subsidiary actors and events. The MOF's decision, however, was final; once it was announced, all the Japanese participants agreed that there was nothing further to be done at the time. There was a one-year review, but this was planned by the MOF, and followed the Ministry's format.

This account describes the external appearance of events and also reflects the views of those who participated. The Federal Reserve made the decision that constituted clearance on the basis of a complaint filed by a trade association representing the opposing side. As soon as it undertook the decision-making process, it knew that it would be sued by the loser; as soon as it issued the decision, it knew the plaintiff would be the SIA, and that its decision favoring Bankers Trust would be reviewed in federal court. It also knew that the loser of the federal court battle would

²⁰⁴ See *supra* note 48 and accompanying text.

²⁰⁵ See *supra* notes 176-78 and accompanying text.

²⁰⁶ See *supra* notes 45-46 & 168-71 and accompanying text.

²⁰⁷ See *supra* notes 48 & 168-71 and accompanying text.

appeal to Congress. Undoubtedly, the Fed hoped it would prevail in both these forums, but it knew that it had not finally resolved the conflict at the preclearance level, and that there would be a great deal of decision-making activity following its action.

The MOF, in contrast, worked hard to resolve the conflict before it issued the decision that constituted clearance. It vigorously utilized an extensive network of contacts, at both the formal and informal level, with both sides in the dispute, and used both existing and specially created study groups to persuade the opposing groups to accept the solution it devised. Once the MOF acted, it expected its decision to be final. Those with whom we spoke agreed that it would be virtually inconceivable for any of the industry groups to bring legal action against the MOF. An appeal to the Diet might have been conceivable, but, for reasons discussed above, it would be unlikely to succeed and might well backfire.²⁰⁸

The fact that the conflict between opposing forces was principally resolved at the preclearance level in Japan does not mean that Japanese authorities were necessarily more effective in resolving the entire conflict than authorities in the United States. The American process reveals a range of postclearance conflict resolution mechanisms that were not present in Japan, most notably litigation and judicial decisions. It is a mistake to see the resort to litigation as a breakdown in the decision-making process; rather, it was an integral part of that process. The various participants, both private and governmental, were able to argue their positions in the courts and the judges added their views in developing the ultimate resolution.

If litigation was not a breakdown in the American decision-making process, neither was it the endpoint of that process. The final resolution (here, as in Japan, subject to reconsideration in light of subsequent events) was announced by the Federal Reserve, and approved by the courts. In other words, litigation may be viewed as one step in the decision-making process, one that is not qualitatively different from other steps, but is rather a natural part of a post-clearance conflict resolution. The courts themselves perceived their decisions in this light. When the Supreme Court reversed the Federal Reserve Board's first decision, and declared commercial paper to be a security,²⁰⁹ it added the broad hint that it was not

²⁰⁸ See *supra* notes 133-37 & 199 and accompanying text.

²⁰⁹ See *Bankers Trust I*, 468 U.S. 137, 140 (1984).

deciding that Bankers Trust's commercial paper operations constituted underwriting.²¹⁰ It thereby invited the Board to issue a new decision on this point, a decision which could—and did—produce an opposite result from its own.²¹¹ Similarly, when the Second Circuit approved this later Board decision, it recognized that this decision could be altered or reversed by congressional action.²¹²

While litigation and legislation should thus be regarded as conflict resolution mechanisms, like the various study groups and planning efforts that the Japanese employed, their use points to some basic differences between the preclearance and postclearance approaches. Postclearance decision-making is segmented into a series of distinct stages, with formal boundaries between them and a decision of some sort being announced at each stage. Preclearance decision-making, in contrast, is agglutinated into a continuous process of compromise and reconsideration, without boundaries or tentative decisions.

These relationships follow naturally from the character of clearance as the distinguishing event. Once clearance has occurred, and the initially responsible decision-maker has issued its announcement, the focus of decision-making must move to some other entity, generally one with juridical power to reverse the original one. If the process is to be coherent, that power cannot be invoked until the initial decision is announced; that is the reason that American appellate courts will generally deny jurisdiction until a "final" agency decision is made.²¹³ In contrast, if the conflict resolution process occurs at the preclearance stage, the interactions between participants must remain fluid and informal. Otherwise, the decision-maker's position will become apparent, and it will be unable to organize a compromise that is acceptable to the participants.

²¹⁰ See *id.* at 160 n.12.

²¹¹ See *Bankers Trust II*, 807 F.2d 1052, 1055 (D.C. Cir. 1986) (describing the Federal Reserve Board's unpublished opinion), *cert. denied*, 483 U.S. 1005 (1987).

²¹² See *Bankers Trust III*, 839 F.2d 47, 52 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

²¹³ See, e.g., *Abbott Laboratories v. Gardner*, 387 U.S. 136, 148-51 (1967) (discussing interpretation of "finality" for purposes of jurisdictional question); see also Administrative Procedure Act, 5 U.S.C. § 704 (1988) (providing that "[a] preliminary, procedural, or intermediate agency action or ruling not directly reviewable is subject to review of the final agency action").

In essence, preclearance decision mechanisms are inherently fluid and informal, while postclearance mechanisms are inherently formal and segmented. Thus, to the extent that a particular society opts for preclearance mechanisms, it will tend to adopt informal strategies as well. Similarly, if a society opts for postclearance decision procedures it is also likely to choose formal strategies. Conversely, as a society adopts formal or informal strategies, it will tend to adopt postclearance or preclearance mechanisms. It is the linkage that is being asserted, not the direction of causality. In fact, the relationship that forges this linkage is almost certainly a co-causal one.

Litigation, the source of Derek Bok's recriminations against American society,²¹⁴ is clearly a central and intrinsic element in a postclearance strategy of conflict resolution. However, to ascribe the choice between preclearance and postclearance strategies to a preference for litigation is too simple. That choice relates, rather, to the ideals and the conceptual patterns of the relevant actors. For Japanese decision-makers, the ideal seems to be rational planning and consensus building. Open conflict is anathema to them; they would regard a public challenge to their announced decision as either an insult or a disgrace. Preclearance conflict resolution satisfies this ideal, because it seems to follow an orderly, administrative planning process which suppresses open conflict. In contrast, the ideals of American decision-makers are openness, fairness, and adherence to principle. They choose to make their decision and then defend it in a public arena. To be challenged or sued by a trade association like the SIA is a sign of independence, not disgrace. The informal preclearance decision-making that the Japanese employ would smack of backroom deals and supine corruption in the American context.

This does not mean that Americans are willing to relinquish any claim to consensus and rational planning, or the Japanese are willing to concede that they are unfair or corrupt. But choices between decision-making models must be made, and each choice naturally shades toward a particular ideal. The need to make a choice which actuates one ideal, when combined with the desire to retain the other, causes each model to incorporate some elements of the other, sometimes consistently, sometimes not. For example, while the Japanese process did occur largely within the confines of

²¹⁴ See Bok, *supra* note 8, at 575-76.

the MOF, its deliberations were hardly a closely guarded secret. To the contrary, all parties to the dispute were well-informed throughout the MOF's deliberations, and the essential facts were widely reported in leading financial journals.²¹⁵ The widespread sharing of information among participants in a preclearance decision process is, indeed, essential to the effective function of that process with respect to decisions of any complexity, which will ordinarily be made through a series of subsidiary decisions. The process of vetting and consultation would not work effectively unless all parties knew which matters have been decided already, which have been excluded as not currently at issue, and which matters are presently under active consideration. The point is not so much that the dispute in Japan was resolved through a process that was secret as that the mechanism for resolving the dispute was private—it involved informal proceedings and extensive vetting of positions in advance and in place of public confrontation.

Nor was the American experience wholly a confrontational, public, litigation-driven phenomenon. There was a close working relationship between the Federal Reserve Board and Bankers Trust throughout the process; although the Board undoubtedly refrained from inappropriate *ex parte* contacts with Bankers Trust while cases were pending before it, there was nothing to stop private consultations between the bank and the agency prior to the initiation of contested proceedings.²¹⁶ The same cannot be said, however, for the big U.S. securities firms, which did not have the same sort of privileged access to the Board and which adopted an essentially confrontational and hostile position towards the Board throughout the proceedings. These firms would have enjoyed better access to the Securities and Exchange Commission, but that agency had little power to influence the outcome of the Board's deliberations—unlike the Securities Bureau of the MOF, which was able to influence the outcome in Japan by virtue of being a division of the agency charged with making the decision.²¹⁷

Thus informal contacts were important in the United States, and, conversely, the Japanese controversy was not wholly devoid of the type of public, confrontational, formalized process which we have associated with a postclearance approach to dispute resolution. These convergences between models are natural ways of satisfying

²¹⁵ See *supra* notes 155-69 and accompanying text.

²¹⁶ See *supra* notes 43-44 and accompanying text.

²¹⁷ See *supra* text accompanying notes 167-70.

conflicting ideals, but they do not alter the predominant pre-clearance and postclearance character of the two models as a means of explaining the different characteristics of the dispute-resolution process we observed in the two settings.

B. *Comparing Preclearance and Postclearance Approaches*

Having characterized the decision-making process in Japan and the United States, the question that presents itself is how those two processes should be assessed. This is a question of both practical and theoretical significance. From the practical perspective, policymakers in both nations undoubtedly want to improve their government decision-making mechanisms. In addition, the two nations compete for worldwide markets, and the quality of their decision-making will affect their relative success in this arena. From the theoretical perspective, the quality of government decision-making in both countries should tell us a great deal about the effectiveness of their social organizations, and about institutional behavior in general. Since controlled experiments in governance strategies are generally impossible, an investigation of the different approaches adopted by two nations that possess a roughly equal material culture, and confront similar economic problems, represents the closest possible approach to such an experimental situation.

Assessments of this sort are, however, extremely complex. While superficial conclusions such as Derek Bok's broadside against litigation in America may attract attention and contribute to our current orgy of social self-flagellation, they provide no criteria for a real assessment.²¹⁸ If we try to take a more focused approach, however, we are confronted with the difficulty that the criteria to be applied are themselves the product of decision-making styles. Thus, in Japan, excellence in government decision-making is measured by the institution's ability to achieve consensus and develop a rational plan. In the United States, an excellent process is regarded as one that is fair, open, and principled. The criteria for excellence, not surprisingly, correspond closely with the ideals which guide the decision-makers and structure their institutions. In order to make a relative assessment of the two approaches, we need transcendent criteria, that is, criteria that exist apart from the ideals of particular

²¹⁸ See *supra* note 8.

societies. For all practical purposes, however, there are no such criteria.

Lacking any ready means for making a global assessment, the best that can be done is to look at specific qualities, or virtues, of a governmental decision-making process. While we cannot determine the relative importance of each virtue, we can at least trace the extent to which each one is fulfilled. The virtues that we will discuss are the coherence of the process, its responsiveness to circumstances, its efficiency, its political accountability, and its fairness.

The coherence of the decision-making process might initially seem greater in Japan, particularly since it resembles the ideal of rational planning to which Japanese decision-makers aspire. Surprisingly, however, events in the two countries reveal substantially similar results in this area. The Japanese process was orderly and rational; at each step all participants were in general agreement about what had already been decided and was no longer open to question, what was currently on the agenda for decision in the short term, and what had been deferred for later action. The Japanese we interviewed showed exquisite sensitivity to these matters and displayed remarkable unanimity as to the current status of particular questions.

Surprisingly, however, the American process also turned out to evidence a fairly orderly and well-understood decision process. The Federal Reserve Board controlled the agenda of cases that came before it in order to move the process forward in a gradual fashion—deciding first the issue of bank commercial paper and a few other low-risk debt instruments, then corporate bonds, and finally corporate equities. In the same fashion as the MOF, the Board proceeded with great deliberation to allow the market to develop only under tight prudential limitations, which the Board, like the MOF, indicated could be loosened over time if the initial experiment with bank commercial paper activities proved successful. The Board was thus able to achieve a policy objective through a well-defined process of gradual deregulation.

It may seem as if postclearance events, particularly the litigation and the court decisions, disrupted the Fed's decision-making process to an extent that did not occur in Japan. But the Fed managed to move forward despite the Supreme Court's reversal of its initial decision that commercial paper was not a security. One might conclude that the Fed was able to recoup its position by using a different set of interpretive arguments. A stronger thesis, which

might well be justified, is that the Fed managed to incorporate the Supreme Court decision into its own decision-making process. It experimented with the solution of excluding commercial paper from the category of securities. Having been informed by the Supreme Court that this solution would not work—much as the MOF might have been informed by the law professors in its study group—it then pursued another approach. The Supreme Court certainly contemplated such a course of events, and its invalidation of the Fed's first resolution does not seem to have diverted the agency from its basic plan.

Conversely, the Japanese process, despite its well-planned appearance, reveals a heavy imprint of interest-group involvement. Powerful private organizations such as *Keidanren* (the Federation of Economic Organizations), the Securities Industry Association, and the City Bank Roundtable were in regular contact with MOF decision-makers. While these decision-makers undoubtedly thought that they were acting for the nation's benefit, they also knew that they had to satisfy these groups, and their decision-making process revealed several significant changes in direction as a result. For example, the entire planning process seems to have been initiated in response to pressure from *Keidanren* and the Securities Industry Association. Furthermore, the decision to allow only dealer paper backed by banks was clearly an effort to de-fuse bank opposition. While the process appears more orderly because these pressures and counterpressures were played out at the preclearance stage, the difference between the Japanese process and the American process may be precisely one of appearance. It may, in fact, reflect Japan's greater devotion to an ideal of rationality, rather than any significant difference in the level of rationality itself.

Apart from the orderliness and rationality of the decision-making process, another virtue of that process is its responsiveness to outside circumstances. Here, the American version seems superior. Because it was segmented, with a relatively smaller proportion of the total process occurring at the preclearance stage, it was easier to initiate. One firm, Bankers Trust, was able to attract the regulator's attention by sticking out its corporate neck, and the subsequent objection by a trade association quickly produced the first decision, the event of clearance in our terminology. The postclearance events that led to the final decision followed in fairly rapid succession.

In Japan, there was much more regulatory inertia. The MOF, perceiving commercial paper as an unwelcome intrusion into the

orderliness of its administrative dominions, remained immovable throughout the early and mid-1980s. Neither the securities industry, *Keidanren*, the Diet, nor the United States of America could induce the MOF to take action. Without action by the MOF, a commercial paper market could not develop. A private institution taking action on its own, as Bankers Trust did in the United States, was simply inconceivable. In short, the Japanese preference for resolving all relevant conflicts at the preclearance stage gave the agency responsible for clearance a virtual stranglehold on the initiation of the decision-making process. The Japanese ideal of consensus made MOF's decision-making rational and orderly once it began, but it also made the process difficult to start as long as the MOF or its principal interest group, the commercial banks, did not want it started.

The concept of efficiency involves the cost required in reaching a particular result. One might attempt to measure the cost of the Federal Reserve and MOF decisions in terms of the general social goal of wealth maximization, but that is simply too difficult, and would carry us far beyond the scope of a study on government decision-making. For our purposes, efficiency simply means the costs involved in reaching whatever result was reached. The conventional wisdom, reflected in Derek Bok's charges, is that the American process is less efficient because of the high cost of litigation.²¹⁹ Once again, however, this is much too facile. Both systems are costly in the sense that real social resources are devoted to them. The costs of the American postclearance system are more obvious, but that is simply because they are more public. The costs of litigation—the expensive attorneys, the voluminous briefs, the elaborate hearings—are there for all to see. In Japan, such public displays of disaffection are assiduously avoided, but doing so is itself a costly process. If the conflict is to be resolved at all, there must be extensive meetings, conferences, and social contacts with all the interested parties. Furthermore, experts must be carefully selected and consulted to confer legitimacy on the clearance decisions.

There is, moreover, an element of patterning which increases costs in both systems. Patterning is meant to describe the phenomenon whereby each step in a decision-making process comes to resemble the whole of the process. The phenomenon results from the fact that the totality has moral force; it represents the society's

²¹⁹ See *supra* note 8.

general image about the right way to make decisions, and thereby operates as a consciously available ideal for the decision-makers who design each stage. Thus, in the United States, each separate stage of a segmented postclearance process becomes segmented itself. There are hearings and decisions on preliminary motions, interlocutory appeals, and preliminary decisions. When the Federal Reserve Board failed to act on the SIA complaint, the SIA followed with a formal petition, triggering a final decision. This was a rather expensive way to initiate the clearance decision that was, in the American model, only the first stage of an extended process. In Japan, on the other hand, the preference for preclearance conflict resolution tends to generate preliminary negotiations prior to meetings that are themselves preliminary. The purpose of the *shingikai* (study group) meetings, for example, was to lay the groundwork for the ultimate clearance decision. The participants, however, were unwilling to come into open conflict at these purportedly preliminary meetings. Thus, each meeting was preceded by extensive negotiations, discussions and informal contacts, often occurring over expensive dinners or in other costly settings, that increased the cost of the decision-making process generally. Similarly, substantive decisions were forced further down the administrative hierarchy because any open conflict or disagreement at the higher level was deemed unacceptable.

Another argument in favor of the conventional wisdom that postclearance conflict resolution mechanisms are less efficient involves the costs that the decision imposes upon private parties. The lack of finality in the American decision that constituted clearance undoubtedly imposed certain costs, as uncertainty about legal rules will generally do. But this does not mean that the period of uncertainty will always be longer in a postclearance system. A particular matter can be under consideration as long or longer at the preclearance stage, during which a similar uncertainty will prevail. In fact, the decision-making process occupied approximately the same length of time in the U.S. and Japan, as measured from the time the issue was raised until the time a sense of final resolution was achieved.

There is, moreover, a countervailing phenomenon that may reduce the cost of postclearance conflict resolution to private parties. In the preclearance scenario, where the crucial decisions occur in private, one party or industry group can readily possess superior information about the final outcome. This will tend to produce anticompetitive effects, and increase total costs to private

parties. When issues are resolved in the open, public forums characteristic of postclearance resolution—and assuming the decision-makers are honest, as they generally are in the U.S. and Japan—the parties will have essentially the same chance of predicting the outcome.

Another element of a decision-making process, apart from its internal features such as coherence, responsiveness, and efficiency, is its relationship to outside actors. Part of this relationship can be captured by the notion of political accountability. In both Japan and the United States, the primary decision-maker—the one responsible for clearance—was an administrative agency staffed exclusively by appointed officials. In both nations, moreover, the agency was answerable to the legislature. This was true in Japan because it has a parliamentary system, and it was true in America, despite our presidential system, because the Federal Reserve is an independent agency.²²⁰ In both countries, moreover, the agencies were implementing an explicit statutory scheme. As a result, political accountability can be measured largely by the extent to which the legislature and the statutory scheme controlled the decision-making process.

As we have noted, both Japan and the United States operate under statutes which broadly separate commercial and investment banking, although as the commercial paper dispute vividly illustrates, the separation is breaking down in both countries. Nevertheless, our study reveals subtle differences between the Japanese and American approaches to statutory interpretation. While combinations between banks and industrial firms are illegal in Japan as in the United States, banks in Japan have used informal networks of contacts, traditions, and cross-ownership to maintain the *keiretsu* that continue to perform many of the same functions as the pre-war *zaibatsu* combinations of banks and industrial firms. Similarly, banks in Japan are prohibited from operating securities affiliates by virtue of the Antitrust Law, which effectively bars holding companies of any sort. Yet as we have seen, Japanese banks do maintain de facto securities affiliates, again through informal mechanisms of control. In addition, although article 65 expressly prohibits banks from underwriting securities, banks in practice do underwrite

²²⁰ We do not address here the vexing constitutional question underlying the concept of “independent agencies.” See, e.g., Miller, *Independent Agencies*, 1986 SUP. CT. REV. 41 (discussing the constitutionality of independent agencies).

corporate bonds by making a "moral commitment" to the issuer to purchase any unsold securities and cover issuer defaults.

There are, in other words, extra-legal, or "moral" arrangements in Japan that, in practice, appear as binding as any legal contract, and that allow banks to circumvent some of the putatively applicable statutory commands. These moral commitments are characteristic preclearance mechanisms in that they depend on a private system of incentives and enforcement rather than on any threat of resort to the courts. The official, apparently binding command of the sovereign is respected in form, but in substance may be subordinated to more informal arrangements.

Based on the data we studied, it would appear that in the United States, the legislative commands regarding bank securities activities carried somewhat more force than the analogous rules in Japan. American courts define their task as enforcing the "intent" of the enacting legislature. In commercial cases especially, American courts have occasionally stepped in to overturn private arrangements that preserved the appearance of allegiance to the statutory command while in substance circumventing the law.²²¹ American courts may even insist on adherence to the statutory language when an administrative agency has proposed a different reading; *Bankers Trust I* is an example.²²² And American courts will sometimes enforce a statute in the face of seemingly perverse results,²²³ at least as long as the outcome is not absurd.²²⁴ These are interpretative doctrines characteristic of a postclearance system of dispute resolution, in that the publicly-announced sovereign command is given greater weight in the determination of applicable rules than

²²¹ See, e.g., *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 690 (1985) (holding that stock transferred pursuant to the sale of a business is a "security" for purposes of the Securities Act of 1933 and the Securities and Exchange Act of 1934); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946) (stating that the definition of "security" under the Securities Act of 1933 requires that form be disregarded for substance and that emphasis be placed on the economic reality of the instrument).

²²² See *Bankers Trust I*, 468 U.S. 137, 150 (1984) (rejecting the Board's view that commercial paper is not a "security" for purposes of the Glass-Steagall Act).

²²³ See, e.g., *Tennessee Valley Auth. v. Hill*, 437 U.S. 153, 194 (1978) (stating that the function of the Court is to discern the meaning and intent of enacted statutes and to apply them accordingly, rather than to balance the equities between the litigants).

²²⁴ See, e.g., *Public Citizen v. United States Dep't of Justice*, 109 S. Ct. 2558, 2565-67 (1989) (stating that it would be absurd to interpret the word "utilize" in the Federal Advisory Committee Act to extend the Act's requirements to any group of two or more persons from whom the President or an executive agency had sought advice).

informal understandings that might have evolved among the parties to the rules.

We do not mean to overstate this distinction as it applies to legislative interpretation. Private arrangements often do receive sanction in the United States, even when they might appear inconsistent with the purposes of the enacting legislature—as illustrated by *Bankers Trust III* and *Bankers Trust IV*, decisions that allow U.S. banks to operate large-scale securities affiliates despite the apparent intent of the Glass-Steagall Act. Conversely, the statutory language and perceived intent of the legislature are important in the Japanese system. The difference is subtle, and one of degree rather than kind. Moreover, the present study considers only a statute that was in effect imposed on the Japanese by the American occupation forces; it is possible that the Japanese response to an indigenously-generated statutory command might be quite different from that observed here. Nevertheless, we believe that the distinction between preclearance and postclearance does have explanatory value as applied to statutory interpretation in the two countries. This suggests that American administrative decision-making is more politically accountable to the non-executive branches than is decision-making in Japan. The result is not surprising, but its link to preclearance decision-making styles is significant.

A final consideration, which involves another aspect of the decision-maker's relationship to outside actors, is fairness, that is, how fully each affected party was able to make its views known and participate in the decision-making process. Where individuals are involved, we in the United States recognize this consideration as due process, and we have concluded that it offers benefits for both the accuracy of the result and the subjective feelings of the participants. The same is probably true for institutional participants such as those involved in the commercial paper conflict.

Fairness is an explicit ideal of American decision-makers, but in a number of ways the Japanese process achieved this ideal more successfully. The primary decision-maker in the United States was almost exclusively concerned with the welfare of the banking industry. While the Federal Reserve is a conscientious regulator and cannot be described as being "captured" by the banking industry, the restrictions the Fed imposes, like the latitude it allows, are designed to foster the safety and soundness of banks. Securities firms are largely outside the Federal Reserve's concern and were thus forced into the role of the decision-maker's adversary. The Fed

allowed this situation to prevail because it did not need to resolve the conflict at the preclearance stage; other decision-makers participated after the event of clearance, and the Fed played the role of advocate before those decision-makers, leaving them to provide a forum for participants like the securities firms. Given the Fed's dominant role, however, and its ability to control the result despite the presence of other decision-makers, its adversarial stance toward the securities firms left them largely excluded from the essential aspects of the decision-making process.

The MOF was placed in an essentially different position. To resolve the commercial paper conflict effectively at the preclearance stage, it was obligated to respond to the concerns of both banks and securities firms. It was able to do so because it regulated both fields and thus possessed direct channels of communication with the major industry participants. Often, the relationship between MOF officials and members of the private firms dated back to their college years, especially to the law department at the University of Tokyo from which many participants in the controversy had graduated. Large banking and securities firms also maintained good relations within the MOF by deputizing junior officers to spend a year working there at company expense. In the other direction, senior MOF officials are generally required to retire from government service at age 55, after which they often find important and profitable positions in the private sector.²²⁵

Within the MOF itself the Banking Bureau and the Securities Bureau came into intense competition over the issue of commercial paper. Both bureaus viewed their mandate, in part, as representing the interests of their industry segment within the MOF. At the same time, the MOF's internal policy is to move policy-making officers from bureau to bureau every two or three years. Thus, MOF officials do not come to identify their personal interests totally with the interests of their bureau; the extensive circulation of individuals from bureau to bureau allows the development within the MOF of a network of relationships that permits a form of preclearance within the agency. Thus it was possible for the fundamentals of the commercial paper compromise to be established by a simple process of negotiation between banking and

²²⁵ The process is known colloquially as "*amakudari*" (descent from heaven). See E. REISCHAUER, *supra* note 1, at 187 (noting that "[i]n a ministry, when one of the members of a class reaches the top bureaucratic post of vice-minister probably in his early fifties, all the others must be retired").

securities bureaus, without the intervention of any outside force.²²⁶

The MOF's ability to respond to the concerns of all participants was not simply the product of its broader jurisdiction, but represented a conscious decision-making strategy. This is demonstrated by the existence of another group of participants who lay outside of the MOF's jurisdiction—the industrial firms that would become the major issuers of commercial paper. In Japan, their presence was felt through *Kaidanren*, essentially their trade association, and through the formidable agency that possessed regulatory jurisdiction over their activities, MITI. The MOF was able to include MITI in its decision-making process, and thereby respond to groups that are outside its jurisdiction. Certainly, the groups MITI represented did not have as much influence as the banking or securities industries, but they did have a channel for expressing their views, which is more than was available in the United States.

Thus, the Japanese process seems more fair than the American one, despite the fact that fairness is an explicit value of American decision-making, and a principle by which our decision-making process is designed. But the American process is just as coherent and probably more responsive to changing circumstances, even though these characteristics are an explicit ideal in Japan. Perhaps the irony is too tempting here and suggests caution about these conclusions. The main point, however, is that decision-making is a complex process, and one cannot take a nation's statements about itself, either positive or negative, at face value. This leads us to our final question, namely, the extent to which differences in decision-making strategy reflect differences in culture.

C. *The Influence of Culture*

As we have seen, neither preclearance nor postclearance conflict resolution is obviously superior as a decision-making strategy. Each has its virtues, and each has its disadvantages. More important, perhaps, is that the differences between them are subtle ones; both strategies exhibit roughly similar abilities to handle complex

²²⁶ One set of relationships was not marked by extensive networks of informal contacts: those between the banking and the securities industries themselves. Those relationships were apparently conceived of as fundamentally rivalrous, so that the maintenance of contacts would have been fruitless. Industry officials we talked to indicated that a private settlement of their dispute without the intermediation of the MOF would be virtually inconceivable.

administrative problems. This suggests that the choice between them may indeed be a matter of cultural preference, and not an indication that one nation is more rational or more efficient than the other.

Other studies of Japanese and American society suggest that their choices of decision-making strategies are reflections of much broader cultural styles.²²⁷ The Japanese concern with consensus and their desire to avoid open conflict are well-documented.²²⁸ Perhaps they derive from the homogenous and highly-centralized nature of Japanese society, its need is to find modes of cooperation in a densely-populated region, and its emphasis on tradition and efficient governance as sources of legitimacy. America, in contrast, displays a penchant for formalized decision-making and structured confrontation, perhaps a product of a pluralistic, widely-dispersed society that derives its legitimacy from concepts of law and individual autonomy. Generalizations of this sort are dangerously malleable, but the basic pattern has been repeatedly observed.

Despite the possible cultural origin of the Japanese and American decision-making processes, one cannot simply conclude that we are dealing with two different kinds of human beings. To assess the similarity or difference between decision-makers in Japan and the United States, we must decide whether differences in culture operate as a conceptual framework or a situational context. If they operate as a conceptual framework, then people in the two countries really are different in an essential way. They think differently, and strategies that come naturally to one people are literally inconceivable to the other. The Japanese themselves often take this position. A number of the people we interviewed stated that it would simply be inconceivable for a bank to begin issuing commercial paper without regulatory approval, the way Bankers

²²⁷ See, e.g., E. REISCHAUER, *supra* note 1 (noting that "the dictatorial power of the occupation and the dire economic conditions of the time produced . . . a more comprehensive and delicate system of cooperation between government and business than had ever existed before"); P. TASKER, *supra* note 1, at 47 (remarking that "the strength of the consensus model is . . . a habit of thought shared by households, bureaucrats, managements and workers, confirmed by the systems and customs by which the social group functions").

²²⁸ See, e.g., E. REISCHAUER, *supra* note 1, at 188 (stating that "[i]f the Japanese have a special decision-making process, it is the system of careful and extensive consultation before a decision is arrived at by general consensus"); P. TASKER, *supra* note 1, at 68 (stating that "[i]mportant decisions are made at middle-management level through a process of consensus-building").

Trust did, or for a trade association to sue a regulator, which the American SIA did quite often, and with enthusiasm.

But culture may also operate as a situational context in which decision-makers and decision-making agencies must function. Given a culture that generally values consensus and that has organized its institutions around compromise, a rational decision-maker would seek to achieve its goal through compromise and consensus. This behavior might not stem from an inability to conceive of alternatives, but rather from a recognition of the prevailing realities. It would have been senseless for the MOF to abandon its study groups, eliminate its carefully established network of industry contacts, release its control of the process, and seek a resolution in court. The MOF had a system of conflict resolution that worked reasonably well, and there was no good reason to dismantle it. Similarly, the Federal Reserve was prepared to reach an initial decision in response to an industry complaint, and then defend that position in court. There was no reason to establish an elaborate system of negotiation, since the Fed would probably have been sued anyway, perhaps by both sides instead of one. Moreover, efforts to negotiate with industry representatives might have been seen as illegitimate *ex parte* contact or unsavory overinvolvement with private interest groups.

Proponents of the cultural approach could argue that the rational decision-maker model fails as an explanation because it artificially isolates the decision-maker from its surroundings. The norms of decision-making in Japan and America are different because the two cultures are different; to posit the entire, pre-existing culture as a given, and then look at a single, isolated decision may not make much sense. But there is a certain validity to this approach from the decision-maker's perspective. If the decision-maker's conceptual framework is totally structured by cultural norms, alternative strategies will not even be considered; they will be inconceivable in a very real sense. In contrast, if the decision-maker is choosing, as a rational actor, to follow certain rules because they are cultural norms, alternative strategies will be conceptually available. For the most part, they will be rejected, but they will be considered and occasionally adopted. In other words, when culture operates as an external constraint, rather than as a conceptual framework, its control is looser, its admitted suzerainty less absolute.

As might be expected, the commercial paper conflict indicates that both situations occurred: the decision-makers were rational

actors on some occasions and cultural actors on others. Our Japanese informants said that litigation against the MOF was inconceivable, but the very fact that they could say it meant that they could conceive of it at some level and simply regarded it as very, very inadvisable. In fact, the securities firms apparently did try to circumvent the MOF's decision-making process by appealing directly to the Diet. Had the Diet acted, that would have constituted the event of clearance, and MOF implementation of the new statute would have constituted a series of postclearance events. The securities firms knew that Diet action was unlikely, but they appealed to the Diet in order to put pressure on the MOF. Essentially, they could conceive of and use alternative strategies. Conversely, the Federal Reserve was in contact with the securities firms, and was willing to compromise by placing restrictions on the commercial paper activities of banks. A preclearance resolution was presumably conceivable in this situation, and we know that such solutions are often reached by American regulators.

In the final analysis, however, distinctive cultural patterns did prevail. The Japanese resolved the issue in private, through a series of preclearance negotiations within a single agency, while the United States resolved the conflict through a succession of administrative and judicial adjudications of a relatively formal and adversarial character.

Thus, there is no simple answer to the debate between cultural and rational actor explanations of American and Japanese decision-making. The reason is that both systems of explanation acknowledge the crucial role of the institutional setting in which decisions are made. For cultural theorists, the institutional setting is the embodiment of culture, and particular decisions reflect that same culture in a fashion that makes them continuous with, and indistinguishable from, their setting. For rational actor theorists, the institutional setting creates the framework of rewards and punishments, of opportunities and constraints, which serves as the only possible basis for evaluating action. In other words, human behavior is contextualized in a decisive way that precludes any global distinction between actions controlled by culture and actions based on independent motivations whose consequences are defined by culture.

One might attempt to retrieve crisp distinction between cultural and rational actor explanations by using them to account for the institutional context itself. Clearly, institutions are products of human behavior, and those behaviors presumably lend themselves

to cultural or rational actor explanation. The problem, however, is that there is no initial state, no moment beyond history when institutions are created and then set in motion. Thus, the behaviors that cause institutions to develop are themselves contextualized in precisely the way that precludes the distinction between culture and rational action. The commercial paper decision, although it is the subject of the present study, and can thus be regarded as occurring against a particular institutional background, was also a stage in the development of institutions that will affect further actions. Government officials and executives of banks, investment banks, and issuing corporations will have their behavior conditioned by a set of institutions which includes the new commercial paper market, or will need to take that market into consideration when determining their own self-interest, or—most likely—will do both.

Even if one were prepared to choose a primary force in shaping institutions, that choice might not determine the contours of those institutions in a decisive way. A new way of looking at dynamic systems, called chaos theory, suggests that very small discrepancies between two similar systems will tend, over time, to produce major differences—differences so great, in fact, that the end result of the two systems will have no resemblance to each other, despite their initial similarity.²²⁹ Thus, a minor admixture of cultural influences in a rational action system, or rational actor influences in a cultural system, may be sufficient to destroy the predictive value of the primary explanation.²³⁰

But all of this is a dilemma only if one accepts the framework of current scholarship, that is, if one feels obligated to choose between cultural and rational actor explanations. A better approach is to regard these two models of explanation as alternative means of accounting for observed phenomena. One can apply each in turn, or better still, one can apply them simultaneously, and accept accounts that can be justified only by both explanations. This recognizes the fact that we perceive behavior in both cultural and rational actor terms, and that the actors themselves respond to both types of motivations.

We have proposed precisely this kind of dual explanation for the distinction between Japan's preclearance conflict resolution and American's postclearance approach. The distinction emerges from

²²⁹ See generally, B. MANDELBROT, *THE FRACTAL GEOMETRY OF NATURE* (1977); H. PEITGEN & P. RICHTER, *THE BEAUTY OF FRACTALS* (1989).

²³⁰ See J. GLEICK, *CHAOS: MAKING A NEW SCIENCE* 59-80 (1987).

the cultural proclivities of executives and officials in the two nations, but each mode of behavior made sense to the participants in rational terms, and could be justified in those terms. This dual approach does not abandon the enterprise of explanation, but rather increases its possibilities. By using both approaches, we can treat individuals as rational actors, whose behavior is predictable at the individual level and comprehensible to other human beings from different cultures. At the same time, we can discern general patterns that distinguish cultures, and that reflect differences in attitude as well as circumstances.

Simultaneous explanation is particularly important when dealing with sophisticated nations that interact with one another. To account for interactions of this nature, one must recognize cultural difference and yet allow for comprehension and learning between cultures. This is certainly true of the commercial paper decision. Japanese and American decision-makers were aware of each other's actions, and their own behavior was affected by that knowledge. At the technical level, the Federal Reserve knew that America's major commercial competitors, including Japan, allow their commercial banks to engage in a wider range of securities activities. Its decision to authorize the Bankers Trust program, therefore, was partially designed to move American banks closer to the European-Japanese mode. The MOF, on the other hand, was directly influenced by the existence of commercial paper markets in the United States and other countries, and understood the industrial firms' desire to increase their access to capital markets. Thus, each nation's decision-makers were able to learn from each other, and respond rationally to the challenges its economic rival presented. At the same time, they interpreted what they learned in their own cultural context, and offered culturally distinct responses.

More generally, decision-makers in both nations are aware of each other's decision-making styles. Derek Bok's complaints are just one reflection of the self-evaluation which any large, sophisticated society undertakes. Knowledge of other cultures provides a means of conceptualizing different approaches, of standing apart from certain culturally embedded patterns and evaluating their desirability. Decision-makers in each culture continue to evaluate other cultures from their own cultural perspective, of course, but the interplay of perspectives is capable of releasing creative energies, and improving the decision-making process according to the decision-makers' own criteria. This paper is an effort to contribute to that process of cultural self-evaluation.

CONCLUSION

We have examined the method by which both Japan and the United States allowed banks to enter the business of underwriting and distributing commercial paper at about the same time. These developments, which are enormously significant for financial markets in both countries, present a unique vantage point for comparing and contrasting their administrative processes for dispute resolution. We find that the marketplace dynamics in the two countries were remarkably similar: in both countries, commercial paper represented a threat to the core banking business of extending short term credit to large business firms. In both countries, the banks sought to protect that core business against inroads by the securities industry. Both cases involved intense interest group lobbying, and in both, the outcome of the process was a period of cut-throat price competition between new bank entrants and the existing underwriters. Both cases were affected by globalization of financial markets, although in different ways.

At the same time, the case studies present some remarkable differences between the two countries' approaches. In Japan, the process was largely contained within the four walls of a single agency, the Ministry of Finance, although other agencies did play a marginal role. In the United States, the Federal Reserve Board played a dominant role at the agency level—a somewhat unusual situation in American banking regulation with its multiplicity of agencies—but the process was heavily influenced by the inevitability of judicial challenge to the Board's decisions and by frequent appeals to Congress to resolve the situation. In Japan, the process, although influenced by private action, was tightly controlled by the MOF, whereas in the United States, the appearance, at least, was that private firms were responsible for driving the process forward. The decision process in Japan was generally private, informal, non-litigious, and not publicly confrontational. In the United States, the process was public, formalized, litigious, and confrontational.

We proposed that these differences can be partially captured by the observation that the commercial paper controversy was resolved in Japan by means of a preclearance method, whereas in the United States, the process can be described as one of postclearance dispute resolution. We cautioned that the preclearance-postclearance distinction should not be overdrawn, in that postclearance features are evident in Japan and preclearance features are evident in the United States. Nevertheless, we believe the distinction between

preclearance and postclearance does capture something important about the differences between the two countries in their treatment of the commercial paper dispute. We speculated that the Japanese and American preferences might reflect cultural attitudes—the relatively homogenous and geographically centralized nature of Japanese culture, and the pluralistic, relatively geographically dispersed nature of American culture. At the same time, the choices made by decision-makers in the two nations might be rational responses to an existing institutional context. Neither method is necessarily more “efficient” at resolving disputes than the other; rather, each method may be better adapted to different underlying features in the society.