

THE EMERGENCE OF UNITED STATES MUTUAL FUNDS IN DOMESTIC COMMERCIAL BANKS AND JAPAN

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I. INTRODUCTION

The United States' and Japan's mutual fund industry experienced incomparable growth during the last decade. While the much heralded industry continues to evolve in both countries, their markets now attract new competition. The new entrants into these respective markets are of different complexion. In the United States, commercial banks are the most discussed newcomers to the mutual fund industry. A series of administrative changes served as the catalyst for the entry of commercial banks into the domestic mutual fund industry. In Japan, somewhat like in the United States, a combination of administrative and legislative change will serve as the impetus for intensified competition in the investment trust, Japan's version of the mutual fund, industry. Unlike the United States, commercial bank competition in the Japanese investment trust industry is only a secondary development. In Japan, the gradual opening of markets to foreign competition headlines the investment trust management business.

The American mutual fund business enjoyed a euphoric year in 1993. Powered by low interest rates, total mutual fund assets increased to record levels while every fund-objective category showed gains.¹ Mutual funds that

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1. Tom Siedell, *Which Mutual Funds to Buy Now*, YOUR MONEY, June 1994, at 38, 38.

have invested in Japanese stocks have also done well, returning over seventeen percent in the first quarter of 1994,² and finishing at 15.4% for the year.³ New sales of domestic stock mutual funds hit a record \$128 billion in 1993.⁴ Since 1980, assets in mutual funds have grown nearly twentyfold, to some \$1.8 trillion.⁵ As of September 1993, the U.S. mutual fund market was the largest in the world, boasting 350 mutual fund management companies which controlled nearly \$2 trillion in assets.⁶ The result: twenty-eight percent of all U.S. households today have mutual fund holdings, compared with six percent in 1980.⁷ As a function of the depth and pace of this growth, domestic mutual fund assets exceeded commercial bank deposits in 1994.⁸ Commercial banks have responded by entering the mutual fund business. American mutual fund products provide a product staple that will help keep commercial banks competitive into the next century.⁹ The message is patently clear: domestic commercial banks must continue to enter the mutual fund industry, and the domestic mutual fund industry must continue to enter Japan.

Similarly in Japan, the volume of managed assets in stock investment trusts at the end of 1987 had grown 7.6 times from 1981.¹⁰ In September 1993, Japan ranked third in the world for investment trust control with their management of over Y 47.5 trillion in assets, despite having only twenty

2. *Id.* at 41.

3. John Waggoner, *Foreign funds may rebound; Japanese, Pacific funds may be the best*, USA TODAY, Jan. 5, 1995, at 5B. Last year, Japan's Nikkei stock index rose 13.5%, which helped account for the 15.4% return to investors. It is anticipated that Japanese stocks will continue to do well in 1995 because Japan's interest rates are low, the economy is recovering, and corporate profits are picking up. If the dollar continues to tumble, U.S. investors' foreign holdings will rise in value. For example, "[i]f the dollar falls to 99 yen, 1 million yen would be equal to \$10,101—a 16% rise." *Id.*

4. Jeffrey Marshall, *Rolling the Dice on Asset Management*, U.S. BANKER, Mar. 1994, at 33, 36.

5. Alyssa A. Lappen, *Fund Follies*, INSTITUTIONAL INVESTOR, Oct. 1993, at 39.

6. *Id.*

7. *The Bottom Line*, THE BANKER, Apr. 1994, at 88.

8. William R. McLucas et al., *SEC Enforcement Under Arthur Levitt*, 27 STANDARD & POOR'S THE REV. OF SEC. & COMMODITIES REG. 181 (1994). Consumers' mutual fund holdings are expected to grow at a rate of 15% through the 1990's, compared to four percent for bank deposits. Marshall, *supra* note 4, at 36 (quoting First Manhattan Consulting Group).

9. Borrowings by corporations and small businesses have been falling since the mid 1980's, and in 1991, debt repayments exceeded borrowings by \$11 billion. Commercial bank's share of the short and medium term credit financing of major corporations plummeted from 90% in 1970 to 60% in 1990. Marshall, *supra* note 4, at 38.

10. *The Sustained Rapid Growth of Japanese Investment Trusts*, INSTITUTIONAL INVESTOR, Apr. 1988, at S8.

investment trust management companies.¹¹ Regardless of this impressive growth, Japanese investors withdrew a net ¥ 2.8 trillion from stock investment trusts in the first nine months of 1993.¹² The trusts' lackluster performance has been a factor in its decreased popularity. All but a tiny fraction of the 2,000 Japanese managed investment trusts in Japan underperform similar Japan-orientated funds based in London.¹³ Further, Japanese-based investment trusts generally do not clearly state their investment philosophies, do not provide breakdowns of specific securities owned, rarely identify fund managers, and do not permit prospective purchasers to compare past performances.¹⁴ Any further introduction of American practice, expertise and performance in Japan would invariably make Japanese investment trusts more competitive while giving U.S. fund managers a world of opportunity with a \$1.5 billion pension industry that expects to grow at a rate of ten to fifteen percent in the next decade.¹⁵

Part One of this article will explore the legislative prohibitions against commercial bank sale of mutual funds and the resultant impact on the banking industry. The article then will chronicle the historic change, through administrative guidance and interpretation, away from the rigid legislative rules which isolated commercial banks from competing in the mutual fund industry. In addition, Part One accounts for the allowance of commercial bank entry into the mutual fund industry by highlighting the accompanying limitations.

Part Two of this article provides an overview of the Japanese Security Regulation System and Investment Trust management business. The section next describes the regulatory environment for foreign domiciled funds in Japan. Part Two emphasizes that just as the domestic commercial banks can become

11. GEORGE CURUBY, INVESTMENT TRUST MANAGEMENT BUSINESS IN JAPAN 1 (Curuby & Co. 1993) [hereinafter INVESTMENT TRUST MANAGEMENT] (on file with IND. INT'L & COMP. L. REV.).

12. *Japanese Investment Trusts; Punting in the Dark*, THE ECONOMIST, Jan. 22, 1994, at 78, 78 [hereinafter *Punting*].

13. Eamonn Fingleton, *Mutual Frustrations*, INSTITUTIONAL INVESTOR, Mar. 1990, at 29, 30.

14. James Sterngold, *World Markets; A New Leaf for Japan's Mutual Funds?*, N.Y. TIMES, Jan. 2, 1994, § 3, at 13.

15. Mamoru Aoyama, *Is MPT Applicable to Japan?*, J. PORTFOLIO MGMT., Oct. 1994, at 103.

The recent growth of Japanese pension funds is remarkable. Since the 1970's, growth has been steady at around 15% a year, and this growth is expected to continue in the future. Some researchers project that Japanese pension assets will reach 100 trillion yen by the year 2000, and 200 trillion yen by the year 2010.

competitors, against the odds, in an imposing and highly specialized American market, domestic fund companies can gain market share in a tersely regulated Japanese market. Most importantly, this section is not sympathetic to information access arguments as it provides the legal procedure necessary for U.S. mutual fund entry into the Japanese investment trust industry. It then studies the impact of these regulations on domestic attempts at entry, and details the unprecedented Ministry of Finance opening of the highly compartmentalized investment trust management industry to subsidiaries of Japanese city banks. Part Two concludes that the Japanese investment trust market and regulatory environment is ripe for entry by U.S. mutual fund managers.

II. DEFINITION OF A MUTUAL FUND

An investment company is defined under the Investment Company Act of 1940 as "any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."¹⁶ Investment companies allow small investors to aggregate their assets, access the securities markets, diversify their risk, and share in gains and losses.¹⁷ A mutual fund is a type of investment company whose assets are invested in securities. Open-end mutual funds, the most common form of investment company, must redeem their shares on demand, at a value equal to the net asset value at the next calculation, and must mail the proceeds within seven days.¹⁸ Conversely, the closed-end investment company does not redeem its shares and is more suitable for those who like less liquid securities.¹⁹ Unlike open-end funds, whose issuers redeem shares at net asset value, the closed-end funds' chief disadvantage has been that its shares sell at a discount to net asset value.²⁰

Mutual fund shares differ fundamentally from other types of securities. Investment companies use the security sale proceeds to engage in the business of investing in securities²¹ as opposed to using the newly acquired funds received from their shareholders to finance existing or expanding operations. Unlike typical security shares that evidence an equity position or debt obligation in one company, a share or certificate in a mutual fund represents a pro rata interest in a pooled portfolio of financial assets.

16. 15 U.S.C. § 80a-3(a)(1) (1988).

17. MELANIE L. FEIN ET AL., *MUTUAL FUND ACTIVITIES OF BANKS* § 1.03, at 1-7 (1993).

18. PHILLIP R. MACK, *Recent Trends in the Mutual Fund Industry*, 79 FED. RESERVE BULL. 1001, 1001-02 (1993).

19. *Id.* at 1002.

20. FEIN, *supra* note 17, § 4.03, at 4-16.

21. *Id.* § 1.03, at 1-7.

Under the Investment Advisers Act of 1940, mutual fund advisers must register with the Securities and Exchange Commission (SEC).²² Commercial banks, and any bank holding company as defined in the Bank Holding Company Act of 1956, are specifically excluded from the definition of investment adviser and are subsequently exempt from registration under the Investment Advisers Act of 1940.²³ Commercial banks are therefore not subject to a number of substantive requirements such as the Advisers Act anti-fraud provisions,²⁴ the regulation of performance fees,²⁵ and to the requirement to establish procedures designed to prevent the misuse of non-public information.²⁶

Mutual funds also are required by the Investment Advisers Act of 1940 to register with the SEC.²⁷ The mutual fund must be operated in the best interest of the fund's shareholders.²⁸ Fraudulent practices are expressly prohibited, and violations are subject to SEC enforcement. Shareholder approval is required for a change in investment policy and investment adviser compensation. Further, the use of financial leverage is limited, and transactions between the fund and its affiliates are prohibited.²⁹

"Pursuant to the Securities Act of 1933, mutual funds must provide investors with accurate information about its investment objective, yield, and operating procedures through a prospectus."³⁰ Mutual fund shares must be registered with the SEC.³¹

To determine if the regulatory requirements are met, the SEC reviews disclosure statements and conducts on-site examinations. The SEC reviews fund disclosures about operating plans, management structure, and financial condition. On-site examinations typically probe the funds' valuation techniques, investment activities, management functions, and sales, and liquidation of shares.³²

Because bank advisers are not required to register with the SEC as investment

22. 15 U.S.C. § 80b-3(a) 1988.

23. 15 U.S.C. § 80b-2(11).

24. 15 U.S.C. § 80b-6.

25. 15 U.S.C. § 80b-5. Typically, the investment adviser's compensation is a fee based upon a percentage of the net asset value of the mutual fund. FEIN, *supra* note 17, § 1.04, at 1-11.

26. 15 U.S.C. § 80b-4a.

27. 15 U.S.C. § 80a-8. There are some exemptions to registration for certain specified investment companies. 15 U.S.C. § 80a-6.

28. 15 U.S.C. § 80a-1(b).

29. MACK, *supra* note 18, at 1003.

30. *Id.*

31. See *supra* note 27 and accompanying text.

32. MACK, *supra* note 18, at 1003.

advisers, SEC examiners may not have access to all the books and records normally available when an adviser is registered.³³

III. THE TRADITIONAL LAW GOVERNING BANK SALE OF MUTUAL FUNDS

Since a mutual fund share represents stock, and stock is a security, mutual funds are subject to considerable regulation by the SEC. The Glass-Steagall Act (GSA),³⁴ the oft-cited name for four provisions of the Banking Act of 1933,³⁵ is the federal banking law which severely restricts the securities activities of commercial banks. Where mutual funds have been effectively defined as securities, this act dictates what commercial banks can do with respect to mutual funds.

Before enactment of GSA, commercial banks were significant participants in the nation's capital markets. Indeed, by 1930, bank affiliates were sponsoring over fifty percent of all new securities issues, and forty-one percent of all commercial bank assets were invested in securities or securities-related loans.³⁶ The GSA was enacted to prevent commercial banks from engaging in the securities business, a business practice which ultimately led to fiduciary abuses.³⁷ By 1933, these abuses had helped lower the U.S. economy to unparalleled depths following the 1929 stock market crash. At the height of the depression, forty percent of the nation's banks had failed or were merged. President Roosevelt ordered the temporary close of banks to silence the panic.³⁸ Congress determined that commercial bank securities dealing and underwriting fueled the rampant stock speculation preceding the 1929 stock market crash, ultimately leading to commercial bank failures.³⁹ As a result of the new

33. 15 U.S.C. § 80b-4.

34. Banking Act of 1933, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.A.)

35. *Id.*

36. See SUSAN E. KENNEDY, *THE BANKING CRISIS OF 1933*, 212 (1973); Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 694 (1987).

37. Abuses involving large commercial banks and their securities affiliates included banks making loans to securities purchasers to support artificially elevated securities prices and dumping of non-performing stocks in trust accounts managed by the bank. *Stock Exchange Practices: Report of the Comm. on Banking and Currency Pursuant to S. Res. 84*, 72d Cong., and S. Res. 56 and S. Res. 97, 73d Cong., S. REP. NO. 1455, 73d Cong., 2d Sess. (1933).

38. Don More, *The Virtues of Glass-Steagall: An Argument Against Legislative Repeal*, 1991 COLUM. BUS. L. REV. 433, 436 n.12 (1991).

39. *Id.* at 437 n.16. But c.f. William M. Isaac & Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U. L. REV. 281 (1981) (no link was ever shown between securities activities and collapse of banking system; Act responded to public outcry rather than hard evidence).

legislation, commercial banks would no longer be involved with securities underwriting and dealing.

Section 16 of the GSA prohibits national banks from underwriting securities, but allows them to purchase or sell securities "without recourse, solely upon the order, and for the account of customers."⁴⁰ Section 21 prohibits any firms engaged in the deposit-taking business, including banks, from engaging "in the business of issuing, underwriting, selling, or distributing . . . securities."⁴¹ Section 20 prohibits member banks from being affiliated with any firms that are "engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of . . . securities."⁴² Lastly, section 32 prohibits certain incestuous management relations between member banks and firms "primarily engaged in the issue, flotation, underwriting, public sale, or distribution . . . of . . . securities."⁴³ This formidable legislation has legally separated the investment banking and commercial banking segments of the financial sector.

As applied to commercial bank sale of mutual funds, the GSA has historically been interpreted to mean that a national bank may not operate a stock investment fund for its customers.⁴⁴ Although no provision of the National Banking Act expressly prevents the pooling of trust assets, management of assets, or purchase of stock by a bank for its customers, "the union of these powers gives birth to an investment fund whose activities are of a different character."⁴⁵ A collective investment fund of this type, offered by banks, would be similar to an open-end mutual fund and would be in direct competition with the mutual fund industry. As such, it "involves a bank in the underwriting, issuing, selling, and distribution of securities in violation of [Sections] 16 and 21 of the GSA."⁴⁶

IV. IMPACT OF THE LAW ON THE BANKING INDUSTRY

Open-end and closed-end mutual funds dominate the modern financial products market. Instead of taking a risk on a "pick of the week" with a stockbroker, or accepting a marginal return in a bank certificate of deposit, individual and institutional investors are electing to capitalize on the collective expertise of

40. 12 U.S.C. § 24 (1988 & Supp. V 1993).

41. 12 U.S.C. § 378.

42. 12 U.S.C. § 377 (1988 & Supp. V 1993).

43. 12 U.S.C. § 78.

44. *Investment Company Institute v. Camp*, 401 U.S. 617 (1971).

45. *Id.* at 625.

46. *Id.* at 617.

professionally trained fund managers.⁴⁷ Mutual funds are actively managed by money managers who are often able to generate returns greater than those produced by direct instruments.⁴⁸ This process saves investors the trouble of searching for individual securities.⁴⁹

Because of their liquidity, returns, and diversity, mutual funds offer savings instruments that clearly threaten commercial banks' deposits. "Americans have withdrawn over \$500 billion from low yielding bank accounts from 1990 to 1992 in favor of higher paying investments, such as mutual funds."⁵⁰ In 1992, the public made net purchases of fund shares amounting to \$206 billion while making net withdrawals from their deposit accounts at banks.⁵¹ Many illiquid bank products, such as certificates of deposit (CDs), have prompted this move. Mutual funds offer ease of investment, because of their liquidity, while yielding superior returns when compared to a bank certificate of deposit. Consequently, the mutual fund has supplanted the commercial deposit account as a limited risk sanctuary.

Where shrinking deposits have strained the commercial banks' working capital, and commercial banks must compete with many alternate sources of credit, the economics of the GSA's post-depression banking laws have deteriorated.⁵² The share of financial assets held by banks and thrifts predictably has fallen from fifty-eight percent in 1974 to forty percent in 1991.⁵³ The share of financial assets held by banks is estimated to drop below thirty-five percent by 1995 and below thirty percent in the year 2000.⁵⁴ While banks once dominated business lending, today nearly eighty percent of all such loans came from non-bank lenders, such as life insurers, brokerage firms, and finance companies.⁵⁵ Now institutions and individuals can also write checks on their insurance company policies, get a loan from a pension fund, and deposit paychecks into a brokerage firm money market account.⁵⁶ "It is possible for banks to die and still have a vibrant economy."⁵⁷

47. Douglas E. Klinger, *A Banker's Guide to Mutual Funds*, BANKER'S MONTHLY, Dec. 1992, at 18, 18.

48. *Id.*

49. *Id.*

50. Bernard Baumohl, *Are Banks Obsolete? "Fat, Dumb, and Happy," Commercial Banks are Being Quickly Replaced as Financial Intermediaries*, TIME, June 28, 1993, at 49, 50.

51. MACK, *supra* note 18, at 1001.

52. Baumohl, *supra* note 50, at 50.

53. Richard L. Stern & Jason L. Zweig, *Bank Reform Wall Street Style*, FORBES, Mar. 30, 1992, at 62, 64. Pension funds have 30%, mutual funds and insurance companies have just over 10% each, and others have the rest. *Id.*

54. *Id.* (quoting Richard Crawford of Madison Financial Group, a Washington, D.C.-based consulting firm).

55. Baumohl, *supra* note 50, at 49.

56. *Id.*

57. *Id.* (quoting Edward Furash, a Washington bank consultant).

The historic regulation of commercial banks handicaps their ability to compete in this changing environment. Commercial banks must maintain reserves and pay deposit insurance premiums against their CDs and deposits, which limit their financial flexibility and lead to higher overhead cost.⁵⁸ As fund managers, they are required to do neither.⁵⁹ Commercial banks, therefore, must continue to enter the mutual fund industry to remain competitive for the same dollars that would otherwise be deposited in a savings account or CD.⁶⁰

During the wave of change, commercial banks have evolved from pure credit organizations into astute marketers. As depositors have taken flight from the secure, insured, commercial deposit, commercial banks have responded by eluding the historic constraints of the Glass-Steagall Act. During this metamorphosis, commercial banks have turned to mutual funds to increase fee income, strengthen customer relationships, and expand their customer base.⁶¹

Because they are convenient and offer many consumer options, mutual funds have more appeal than the common trust funds traditionally offered by banks. By selling mutual funds or getting involved as fund managers, banks do not commit capital, yet still retain customers' business and invariably earn a fee.⁶² Unfortunately, the one-time fee from mutual fund sales is hardly a substitute for loan returns, and money placed in mutual funds is unavailable for lending.⁶³ Nevertheless, the transition has been easy because mutual funds are a natural extension of the money management services that trust departments have been engaged in for years.

V. LEGAL AUTHORITY THROUGH ADMINISTRATIVE GUIDANCE FOR THE CONTEMPORARY BANK SALE OF MUTUAL FUNDS

A. *History of Bank Emergence into the Mutual Fund Industry*

The thirty years following the passage of the GSA saw little debate over its merits. In 1972, investment banks and other institutions began competing

58. Jean A. Briggs & William Baldwin, *First National Bank and Fund Co.*, FORBES, Dec. 1, 1986, at 92, 94.

59. *Id.*

60. In 1993, the pressure on banks to enter the mutual funds business was intense. The \$1.8 trillion mutual fund industry was anticipated to quickly overtake the \$2.4 trillion on domestic deposit with U.S. banks. Much of that money used to be on deposit at banks. Lappen, *supra* note 5.

61. J. Christopher Svare, *Mutual Fund Rules and Options*, THE MAG. OF BANK MGMT., Sept. 1972, at 71, 71.

62. John Waggoner, *Giant Banks Step Into Funds; For Many, Attraction is Mutual*, USA TODAY, Sept. 30, 1993, at 1B.

63. Leslie Wayne, *Concern Over Bank Sales of Funds*, N.Y. TIMES, Dec. 31, 1992, at D1.

for commercial bank deposits by introducing money market funds. Although commercial banks already had begun to sell non-deposit investment products, the new competition for money that formerly had been dependable as deposits led those banks to petition federal regulators for permission to engage in non-traditional banking activities not explicitly proscribed by Glass-Steagall.⁶⁴ Extensive litigation resulted as representatives from commercial banks and securities firms appealed to the courts to protect their interests.⁶⁵

The genesis of commercial bank entry into the mutual fund business can be traced to 1966. Citibank established a common trust fund for the purpose of managing agency accounts and registered it as an investment company with the SEC.⁶⁶ In 1971, the Supreme Court held that Citibank's management of the common trust fund/investment company violated the Glass-Steagall Act.⁶⁷ Also in 1971, the Board of Governors of the Federal Reserve (Board) ruled that a bank holding company's management of a mutual fund violated Section 20 of the GSA.⁶⁸

Nonetheless, banks were not completely foreclosed from entering the mutual fund business. In 1972, the Board amended Section 225.4(a) of Regulation Y. Under amended Section 225.4(a)(5), bank holding companies⁶⁹ were permitted, in accordance with Section 225.4(b), to furnish investment advice to an open-end investment company.⁷⁰ This amended provision also

64. See Edward J. Markey, *Why Congress Must Amend Glass-Steagall: Recent Trends in Breaching the Wall Separating Commercial and Investment Banking*, 25 NEW ENG. L. REV. 457, 467 (1990); THOMAS G. FISCHER ET AL., *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467, 470-71 (1984).

65. See *Bd. of Governors v. Inv. Co. Inst.*, 450 U.S. 46 (1981) (upholding Federal Reserve Board's amendment of Regulation Y to permit affiliates of commercial banks to act as advisers to closed-end investment companies); *Sec. Indus. Ass'n v. Bd. of Governors*, 468 U.S. 207 (1984) (upholding Board approval of Bank of America's purchase of Charles Schwab on grounds the GSA was not violated because the bank's affiliate engaged in the purchase and sale of securities "for the account of customers" as permitted by Section 16 of GSA); *Sec. Indus. Ass'n v. Bd. of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (ruling that commercial paper could be placed by a commercial bank because a private placement is not the same as an underwriting, and is therefore not the same as an underwriting which is considered a public offering proscribed by Section 16 of GSA).

66. In the Matter of First Nat'l City Bank (Commingled Investment Account), Investment Company Act of 1940, Exchange Release No. IC-4538, 42 SEC 924 (Oct. 5, 1966).

67. *Inv. Co. Inst. v. Camp*, 401 U.S. 617 (1971). This decision came in the wake of 1970 amendments to the 1933 and 1934 Securities Acts, which provided express exemptions to registration for bank common trust funds.

68. *Board Rulings and Staff Opinions Interpreting Regulation Y: Acquisition of Bank Interests*, F.R.R.S. 4-270.3 (Mar. 1994).

69. The term includes both their bank and non-bank subsidiaries.

70. *Activities Closely Related to Banking—Investment Adviser Activities*, F.R.R.S. 4-177 (Feb. 1, 1972).

authorized bank holding companies to sponsor, organize, and advise closed-end investment companies.⁷¹ In the Board's opinion, however, the GSA provisions, as interpreted by the Supreme Court, forbade a bank holding company to sponsor, organize, or control an open-end mutual fund. Conversely, the Board did not believe that such restrictions applied to the closed-end mutual funds, so long as such companies were not primarily or frequently engaged in the issuance, sale, and distribution of securities.⁷² In 1972, Provident National Bank became the first bank to act as an investment advisor to a closed-end mutual fund named Independence Square Income Securities.⁷³ The introduction of investment advisor services to this fund marked the entrance of the banking industry into the mutual fund business.

Concurrently with this amendment, the Board adopted an interpretative rule outlining the types of relationships a bank holding company may have with a mutual fund and a closed-end investment company consistent with the Glass-Steagall Act.⁷⁴ This interpretative rule governs the manner in which a bank holding company that has obtained Board approval under Section 4(c)(8) of the Bank Holding Company Act may conduct its investment advisory activities. The Board's interpretative rule has been upheld by the U.S. Supreme Court.⁷⁵ Paragraph (h) of the Board's interpretative rule regarding investment advisory activities states that a bank holding company may not engage in the "sale or distribution" of shares of an investment company which is advised by the bank holding company or one of its non-bank subsidiaries.⁷⁶

Despite the prohibition on outright distribution and underwriting of a mutual fund, the Supreme Court has agreed that Section 20 of the GSA does not prohibit a bank affiliate from sponsoring a closed-end investment company⁷⁷ or acting as a discount broker in the purchase and sale of securities for customers.⁷⁸ Such activities for bank affiliates are authorized under the Board's regulation Y pursuant to the Bank Holding Company Act.⁷⁹ Section 20 of the GSA prohibits a member bank from affiliating with a company that

71. The language "serving as investment advisor [sic], as defined in Section 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under the act" was added to the list of activities closely related to banking. *Id.*

72. *Id.*

73. Charles B. Landreth, *Bank Mutual Funds: Growth Vehicle of the 90's; Changes in the Industry*, TR. & EST., Sept. 1992, at 37, 37.

74. 12 C.F.R. § 225.125 (1972).

75. See Bd. of Governors, 450 U.S. at 56.

76. 12 C.F.R. § 225.125(h).

77. Bd. of Governors, 450 U.S. at 64.

78. See *Sec. Indus. Ass'n v. Bd. of Governors*, 468 U.S. 207 (1984); *Sec. Indus. Ass'n v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

79. 12 C.F.R. § 225.25(b)(4). See also 12 C.F.R. § 225.125 (the Board's interpretation of the regulation).

directly, or through a subsidiary, *engages principally* in the issue, flotation, underwriting, public sale, or distribution of securities. The Federal Reserve Board determined that Section 20 subsidiaries would not engage principally in an underwriting or dealing activity if gross revenues from such activities were limited to ten percent of their total gross revenue.⁸⁰ Based on this pronouncement, if a bank refrains from underwriting or purchasing shares of an investment company for its own account and acts only as an investment adviser, it does not violate the requirements of Section 16.⁸¹ The Federal Reserve Board decided that a bank holding company may not organize and manage mutual funds, and that it is unnecessary for a bank holding company to perform all such functions in order to engage effectively in investment advising activity.⁸² Acting in capacities such as registrar, transfer agent, or custodian for an investment company, however, is not a selling activity and is permitted under Section 225.4(a)(4) of Regulation Y.

In 1984, the FDIC continued to relax the legislative constraints on banks by permitting state non-member banks to underwrite mutual funds through "bona fide" securities subsidiaries.⁸³ By 1986, the brokering of mutual funds by bank holding companies was expressly authorized by the Federal Reserve Board.⁸⁴ In 1987, the FDIC rule that allows securities underwriting activities by "bona fide" subsidiaries of state nonmember banks was upheld.⁸⁵ Also in 1987, the Office of the Comptroller and Currency authorized national banks to recommend and broker mutual funds for which the bank acts as an investment

80. See Statements to the Congress; Policy Statements by Members of Federal Reserve System, 76 FED. RESERVE BULL. 301, 313 (1990).

In January 1989, the [Federal Reserve] Board expanded the range of securities that could be underwritten in a section 20 subsidiary to include any debt or equity security except shares of mutual funds. . . . In September 1989, the Board raised from 5 to 10 percent the revenue limit on the amount of total revenues that a section 20 subsidiary could derive from underwriting and dealing in ineligible securities.

Id. at 313-14. But *c.f.* Alternate Revenue Test is About as Far as Fed Will Go on Section 20, 12 BANKING POLICY REPORT 10 (1993) (explaining a Section 20 company "can elect to use either the original 10 percent revenue standard or the alternative indexed revenue test for purposes of calculating compliance"). See also Robert M. Kurucz et al., *Securities and Investment Activities of Banks*, 48 BUS. LAW. 1105, 1110 (1993) (explaining that the FRB issued a final order approving the use by Section 20 subsidiaries of the indexed revenue-based test).

81. *Id.* at 62.

82. 12 C.F.R. § 225.125(e).

83. 12 C.F.R. § 337.4 (1988).

84. *Securities Activities-Disclosure Brokerage Services*, F.R.R.S. 4-655 (Mar. 1994).

85. *Inv. Co. Inst. v. FDIC*, 815 F.2d 1540 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 847 (1987).

adviser.⁸⁶ Perhaps the clearest and broadest administrative changes came in 1992. In July 1992, the Federal Reserve Board approved a revised interpretation authorizing bank holding companies to broker and recommend mutual funds for which an affiliate acts as an investment adviser.⁸⁷ In September of the same year, the Federal Reserve Board amended regulation Y and added to the list of permissible bank holding company activities full-service brokerage and expanded investment advisory.⁸⁸

The role of banks with respect to mutual funds, in accordance with the above rules, has been limited to advisor, seller, custodian, transfer agent, shareholder servicing, and administrator. Under no condition may a bank underwrite or distribute mutual funds. Although the GSA does not explicitly define the term "distribution," it has been interpreted to be similar in scope to traditional "underwriting" of newly issued securities.⁸⁹ While an underwriter actually provides the initial capitalization, the distributor organizes the fund; registers with the SEC; prepares the prospectus, marketing materials, proxies, and shareholder reports; and arranges for credit lines. Banks need an underwriter or distributor independent of the bank itself to create the investment company.⁹⁰ GSA prohibits such activities due to concerns that they are too speculative for national banks and may subsequently expose them to other subtle hazards. The legislation prevents commercial banks from purchasing mutual fund shares from the issuer, in their own account, independently or in conjunction with other underwriters who also purchase and sell the particular issue of mutual funds as principals. Commercial banks may, however, take an active role in marketing, such as providing brokerage and investment advisory services to customers—and advertising related to those services. Commercial bank assets are therefore not exposed to the type of risks traditionally associated with underwriting and distribution.

B. *The Law and Procedure for the Bank Sale of Mutual Funds*

In pursuing mutual fund opportunities in retail sectors, banks have three options. First, they can manage and advise proprietary mutual funds, which

86. OCC Interpretative Letter No. 403, *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,627 (Dec. 9, 1987).

87. 57 Fed. Reg. 30,387 (1992).

88. 57 Fed. Reg. 41,381 (1992).

89. *See Securities Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 217 (1984) ("terms 'underwriting' and 'distribution' traditionally apply to functions different from that of a securities broker").

90. Malcolm P. Northam, *Mutual Funds . . . Beyond the Interagency Statement, Opportunities for Financial Institutions* (Federal Financial Institutions Examination Council, Arlington, Va., 1994) (on file with IND. INT'L & COMP. L. REV.).

are underwritten by an unaffiliated distributor.⁹¹ Second, they can earn commission income by acting as a broker for mutual fund products offered by established mutual fund sponsors. This option requires minimal effort and capital investment.⁹² Third, banks can make available "private-label" mutual funds which bear names designated by the bank, but actually are existing funds sponsored by an unaffiliated company.⁹³

1. *Banks as Advisers and Proprietary Fund Managers*

Regulation Y specifically authorizes bank holding companies to act as investment advisers to registered investment companies.⁹⁴ When the Board of Governors amended Regulation Y to add "serving as an investment advisor," it felt the service should be added to the list of activities so closely related to banking as to be a proper incident thereto.⁹⁵ The principal activity of an investment adviser is to manage the investment portfolio of its advisee and to invest or reinvest the funds of its client.⁹⁶ Banks that act as investment advisers to mutual funds merely perform a traditional banking service in the form of giving investment advice to customers on a commingled basis. Banks are permitted to perform this function by organizing mutual funds in the form of common trust funds for their trust customers.⁹⁷ These trust funds are nothing more than mutual funds that are excluded from the definition of investment company.⁹⁸

This interpretation withstood a challenge by the Investment Company Institute, which unsuccessfully argued that the regulation violated the GSA.⁹⁹ Although the interpretation says that the GSA precludes a bank holding company from sponsoring, organizing, or controlling an open-end investment company, the Board of Governors reasoned that the GSA does not prohibit a bank holding company from sponsoring, organizing, or controlling a closed-end investment company that does not engage primarily in the issuance, sale, or distribution of securities.¹⁰⁰ The bank or bank holding company, therefore, may exercise all functions of an investment adviser under the 1940 Act, except to the extent limited by the GSA.¹⁰¹

91. Svare, *supra* note 61, at 71.

92. *Id.*

93. *Id.*

94. See 12 C.F.R. § 225.25(b)(4)(ii).

95. See Investment Adviser Activities, 12 C.F.R. § 225.125(a).

96. See *Inv. Co. Inst. v. Camp*, 401 U.S. 617.

97. 12 C.F.R. § 9.18 (1984).

98. FEIN, *supra* note 17, § 5.02, at 5-5.

99. See Bd. of Governors, 450 U.S. 46 (ICI II).

100. See 12 C.F.R. § 225.125(f).

101. *Id.* § 225.125(d).

The Office of the Comptroller of the Currency (OCC) also has interpreted the National Bank Act to permit national banks to act as investment advisers to mutual funds.¹⁰² In an interpretative letter, the OCC explained that neither a bank nor its subsidiary could control any investment company.¹⁰³ The OCC added that any bank or subsidiary engaged in investment advisory activities was prohibited from distributing or underwriting mutual fund shares and that all of the fund's directors must be independent of the bank.¹⁰⁴ These restrictions are exemplified through commercial bank advisory and sale of proprietary funds. A proprietary fund is one for which the bank acts as an investment advisor and which is marketed primarily to the bank's customers.¹⁰⁵ Banks frequently have used proprietary funds as investment vehicles for trust assets held by them as a fiduciary. Because of Glass-Steagall restrictions on underwriting and distribution of securities, the proprietary funds of banking organizations must be organized and distributed by an independent distributor.¹⁰⁶ In the Federal Reserve Board's opinion, the GSA provisions, as interpreted by the U.S. Supreme Court, still forbid a bank holding company to sponsor, organize, or control a mutual fund.¹⁰⁷

On April 21, 1993, the Federal Reserve Board gave Mellon Bank approval to provide administrative services to mutual funds.¹⁰⁸ In the order, the Board stipulated that control over the mutual funds must remain with the funds' boards of directors—*independent of The Boston Company and Mellon Bank*.¹⁰⁹ Despite overwhelming control over mutual funds, the Mellon Bank would not be considered in control on account of the board of director influence. As a result of this interpretation, Section 20 affiliates are free to sponsor,

102. See 12 U.S.C. § 1831a. See also 12 C.F.R. § 337.4.

103. Letter of David L. Chew, Senior Deputy Comptroller, *reprinted in* Fed. Banking L. Rep. (CCH) ¶85,468 (1984). See also Decision of the Comptroller of the Currency concerning an application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (Sept. 2, 1983), *reprinted in* Fed. Banking L. Rep. (CCH) ¶99,732.

104. *Id.*

105. FEIN, *supra* note 17, § 4.06, at 4-26.

106. *Id.* at 4-27.

107. 12 C.F.R. § 225.125(f). In approving Mellon Bank's application to acquire The Boston Company, a mutual fund administrator, the Federal Reserve Board stated The Boston Company would not be allowed to sponsor or distribute new mutual funds following the acquisition because of GSA prohibitions. *Mellon Bank Corporation*, 79 Fed. Res. Bull. 626, 629 (1993).

108. These services would be provided due to the acquisition of The Boston Company, a mutual fund service provider. *Dingell, Markey Want Answers From Fed on Scope of Recent Mutual Fund Approval*, BNA Daily Rep. for Executives, May 7, 1993 (1993 DER 87 d11), available in WESTLAW, BNA-DER file.

109. *Id.*

underwrite, or distribute mutual funds "so long as they meet existing Fed tests for Section 20 activity."¹¹⁰

Commercial banks in 1995 engage in investment advisory activities that are comparable to, and competitive with, the services of registered securities firms and investment advisers. Unlike bank transfer agents and bank municipal and government securities activities, which are regulated under the federal securities laws, bank investment advisory services are administered outside the federal regulatory scheme. Without SEC oversight, 119 commercial banks in 1994 provided investment advice to over \$312 billion in mutual fund assets, representing approximately fifteen percent of total mutual fund assets.¹¹¹

2. *Banks as Brokers*

The Federal Reserve Board has determined that securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory services, are not deemed to be the underwriting, public sale, or distribution of the securities prohibited by the Glass-Steagall Act. The U.S. Supreme Court has upheld that determination.¹¹² Congress gave a national bank the authority to purchase and sell a mutual fund share. This express authority was given in the language "upon the order, and for the account, of customers."¹¹³

On April 22, 1992, the Federal Reserve Board adopted final regulations, adding to the Regulation Y list of activities that are "closely related to banking."¹¹⁴ Specifically, the Board allowed bank holding companies that receive or have received approval to engage in brokerage to sell, solely as an agent or broker for customers, to broker shares of proprietary mutual funds.¹¹⁵ The rule requires that any bank holding company that provides securities brokerage in connection with the shares of a proprietary mutual fund must: (i) disclose its dual roles to customers; (ii) caution customers to read the prospectus of the fund before investing; and (iii) advise customers in writing that the fund's shares are not deposits, are not obligations of any bank, are not insured by the Federal Deposit Insurance Company (FDIC), and are not endorsed or guaranteed by the bank in any way.¹¹⁶ The purpose

110. *Id.*

111. See LIPPER ANALYTICAL SERVICES, INC., BANK-RELATED FUND ANALYSIS (Fourth Quarter 1994) (on file with IND. INT'L & COMP. L. REV.).

112. See *Sec. Indus. Ass'n v. Bd. of Governors*, 468 U.S. 207.

113. 12 U.S.C.A. § 24 (1994).

114. 57 Fed. Reg. 41,381, 41,387 (1992) (to be codified at 12 C.F.R. § 225.25).

115. 57 Fed. Reg. 30,387.

116. 57 Fed. Reg. 30,391 (1992) (to be codified at 12 C.F.R. § 225.125).

of this regulation is to alert the public that bank-sold mutual funds are not insured or guaranteed by the bank itself.

Banks that engage directly in securities activities are excluded from the definitions of "broker" and "dealer" in the Exchange Act, and are therefore exempt from broker-dealer regulation under the federal securities laws with the exception of the antifraud provisions.¹¹⁷ Banking regulations do not establish specific qualification and continuing education for securities salespersons, and do not provide for the statutory disqualification of bank securities salespersons with disciplinary histories. Despite the foregoing, in 1994, over 1800 banking firms sold mutual funds to their customers.¹¹⁸

3. *Bank Sales of Private Label Funds*

Specialized bank products, such as "private label" mutual funds, have also evolved. Private label mutual funds have an unaffiliated investment adviser, but are marketed and sold by the bank directly to bank customers. Typically, these funds will bear a name that is identified with the marketing bank. Banks and thrifts recommending or selling such products should ensure that customers are fully informed that the products are: (1) not FDIC insured; (2) not deposits or other obligations of the institution and are not guaranteed by the institution; and (3) involve investment risks, including possible loss of principal. These disclosures must be made in a clear and conspicuous manner.¹¹⁹

VI. CONCLUSION OF PART ONE

As of March 31, 1992, banks managed ten percent of the \$1.428 trillion in U.S. mutual fund assets, up from less than five percent in 1987.¹²⁰ Assets of bank-related equity funds have grown nearly sevenfold since 1987, while assets of bank-managed fixed-income funds have increased tenfold.¹²¹ The number of banks selling mutual funds climbed from 502 to 736 in the first six months of 1993, nearly triple the amount that existed in 1987,¹²² and now accounts for fifteen percent of all the stock and bond mutual fund shares

117. 15 U.S.C. § 78j (1988) (proscribing the use of manipulative and deceptive devices in connection with the purchase or sale of any security by "any person").

118. See Michelle Clark, *Call Reports Show Surprisingly Few Banks Selling Funds*, AMERICAN BANKER, Aug. 25, 1994, at 12.

119. FED. DEPOSIT INS. CORP., INTERAGENCY STATEMENT ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS (Feb. 15, 1994).

120. Landreth, *supra* note 73, at 37 (quoting Lipper Analytical Services).

121. *Id.*

122. *Id.*

sold in the United States.¹²³ Putnam reports that several hundred bank relationships produced thirty percent of its retail sales generating \$4 billion in 1992.¹²⁴ If those numbers do not entice banks to enter the business, then the fact that twenty-five million Americans were in the forty-five to fifty-five age group in 1990, and that there will be thirty-six million in that group by the year 2000, should provide the incentive.¹²⁵

The mutual funds' reaction to banks' in-house brands is indifferent so far. Most fund companies seem to perceive little threat.¹²⁶ Nevertheless, banks have a strategic selling advantage in the unparalleled power of their distribution network.¹²⁷ Banks also have established relationships, objectivity, and a reputation for integrity.¹²⁸ There is little to support the argument that they cannot become major forces in the mutual fund industry.

PART TWO

VII. THE EMERGENCE OF U.S. MUTUAL FUNDS IN JAPAN

As in the United States, the size of Japan's mutual fund industry has grown exponentially during the last twenty years. Japan's investment trust market, the Japanese equivalent of the U.S. mutual fund industry, is one of the world's largest at \$465 billion. Unlike the United States, where each fund is an individual company, each investment trust management company in Japan may run many funds as separate investments—not companies. As a practical matter, the securities investment trust market has been exclusively dominated by Japan's four largest securities firms (the "Big Four": Daiwa, Nomura, Yamaichi, and Nikko) and twelve other securities firms, each of which is affiliated with the Big Four.

Unlike the United States, continued expansion of the investment trust business will not come as the result of bank entry into the business. Rather, the premier entrant into Japan's investment trust business will be foreign competition. Foreign investment trust funds have been allowed to offer shares to the Japanese public since the end of January 1973, and only then if they fulfilled the requirements of "Regulations Concerning the Trading in Foreign

123. Lappen, *supra* note 5.

124. *Id.*

125. Lyn Perlmuth, *Banks Muscle into Mutual Funds*, INSTITUTIONAL INVESTOR, Mar. 1992, at 59, 63.

126. Suzanne Woolley, *Mutual-Fund Houses Start to Hear Footsteps*, BUS. WEEK, Feb. 3, 1992, at 68, 68.

127. Some fund groups and banks report that 20-30% of their sales are made through branches. *Id.*

128. *Id.* at 69.

Securities" stipulated by the Japan Securities Dealers Association.¹²⁹ After 1990, foreign firms were permitted to establish mutual fund activities in Japan.¹³⁰ Despite the entry of five foreign mutual fund companies in the last four years, U.S. mutual fund companies have been noticeably absent from the market. This absence is primarily due to high entry-cost barriers and the peculiar nature of the mutual fund industry in Japan. Regardless of these challenges and barriers, the investment trust market in Japan presents enormous opportunity for U.S. expertise.

In 1990, twelve percent of the Japanese population were aged sixty-five and over, making it younger than the United States or Western Europe. By 2010, twenty-one percent of the population will be in that bracket, thereby making Japan the greyest part of the industrial world.¹³¹ Japan's pool of pension assets presently amounts to more than Y 65 trillion (\$500 billion).¹³² Japan's investment trust industry manages a further Y 50 billion (\$430 billion).¹³³ Management of these assets can become a highly lucrative business for U.S. companies.¹³⁴ "By law and custom, participation in both of these markets is dominated by large Japanese financial institutions."¹³⁵ Despite this impressive market size and cartel-like concentration of firms, foreign firms have been marginalized in the participation of Japanese money management. "[F]oreign investment trust managers have only 1.1% of the Japanese mutual fund industry."¹³⁶ Further, foreign firms presently manage less than 0.2% of Japan's total pension assets.¹³⁷ "In contrast, foreign firms manage more than eight percent of U.S. pension assets."¹³⁸

A. *Historical Overview of the Securities Regulatory System*

Japanese securities companies and the market structure of the securities industry historically have been the beneficiaries of protective legislation. Unlike the United

129. THE INVESTMENT TRUSTS ASS'N, INVESTMENT TRUSTS IN JAPAN 5 (1993) (on file with IND. INT'L & COMP. L. REV.) [hereinafter INVESTMENT TRUSTS].

130. MINISTRY OF FINANCE, GUIDELINES FOR LICENSING INVESTMENT TRUST MANAGEMENT COMPANIES 1 (Dec. 14, 1989) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter GUIDELINES].

131. Aoyama, *supra* note 15.

132. U.S.-JAPAN BUSINESS COUNCIL, JAPAN'S FINANCIAL SERVICES MARKET: THE CASE FOR EXPANDED ACCESS 14 (June 3, 1993) (on file with IND. INT'L & COMP. L. REV.) [hereinafter U.S.-JAPAN BUSINESS COUNCIL].

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

States, which allows, to a great extent, market forces — and not government regulation — to determine the financial order of its markets, the number of securities firms and investment trusts in Japan is dependent upon existing legislation. This legislation permits screening and licensing by the Ministry of Finance (MoF) and greatly limits the number of entrants into the market. The regulation of securities firms differs from the regulation of investment trust management companies. Regulations in the securities industry were relaxed earlier and to a greater extent than regulations governing the investment trust management business.

Modeled specifically on the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934, Japan's Securities and Exchange Law (SEL) provides investor protection through mandatory disclosure and anti-fraud rules.¹³⁹ The SEL specifically regulates the securities industry and not the investment trust business. Thus, when a securities firm desires to issue "securities," it must file a registration statement with the MoF and comply with reporting requirements.¹⁴⁰ Certain rules, such as Article 65, also limit who is eligible to sell securities. Article 65 of the SEL is similar to the U.S. GSA because it essentially prohibits banks from entering the securities business.¹⁴¹

The Japanese economy was marked by a period of depression from 1961 to 1968.¹⁴² In July 1961, Japan's credit markets tightened.¹⁴³ In an effort to procure new capital, corporations flooded the stock market with new issues and offerings of stock.¹⁴⁴ By the spring of 1963, the increase in stock supply, coupled with the cancellation of stock investment trusts, had serious repercussions on the stock market.¹⁴⁵ In 1965, the Japanese Securities Holding Association was organized by the securities companies, with the aid of the Bank of Japan, to acquire "excess stocks arising from the cancellations of investment trusts and stockholdings of securities companies."¹⁴⁶ After February of 1965, capital increases were suspended.¹⁴⁷ These events ultimately served as the impetus for change in Japanese securities regulation.

139. Megumi Suto, *The Securities Industry in Japan*, in JAPANESE CAPITAL MARKETS 164, 168 (Shinji Takagi ed., 1993).

140. *Id.* at 168-69.

141. *Id.* at 180. The history of Japan's adoption of Article 65 differs from the United States' adoption of the Glass-Steagall Act. Unlike the United States, which adopted the GSA to protect depositors' interests and prevent banks from making speculative investments, Article 65 was adopted in Japan at the insistence of the U.S. government during the occupation to protect a fledgling broker business from the competitive and established city banks. J. ROBERT BROWN, JR., OPENING OF JAPAN'S FINANCIAL MARKETS 29 (1994).

142. JAPAN SECURITIES RESEARCH INSTITUTE, SECURITIES MARKET IN JAPAN 17-18 (1992).

143. *Id.* at 17.

144. *Id.* at 17-18.

145. *Id.* at 18.

146. *Id.*

147. *Id.*

In 1965, the SEL was fundamentally revised.¹⁴⁸ Amendment of SEL was "aimed at substituting a licensing system for the prevailing registration system for securities companies . . ."¹⁴⁹ In addition to Article 65's limitations on who may actually sell securities, the licensing system regulated who could engage in the separate activities of underwriting, brokerage, distribution, and dealing.¹⁵⁰ A firm can be licensed in all four areas only if it has equity capital of one billion yen.¹⁵¹ The MoF further restricts the expansion of the marketplace through administrative guidance on the behavior of securities companies, the position of balance sheets, the introduction of new financial products, and limitations on the number of member firms at the securities exchanges.¹⁵² The objective of this regulation is to maintain the stability of the financial system and to protect investors from what authorities call "excess competition."¹⁵³

After the introduction of the reforms in the wake of the securities panic of the early 1960's, the number of securities companies decreased drastically from a peak of 564 in 1962 to 255 at the end of 1968. This decrease can be attributed to the high standards that the MoF requires a company to meet before it can obtain a license.¹⁵⁴ The number of branch offices also declined from 2,853 to 1,825 during the same period.¹⁵⁵ Since 1968, the number of securities firms has continued to decrease, leaving only 210 in 1990. Among some 200 firms, full service securities operations has been highly concentrated in a small number of integrated companies, especially the Big Four.¹⁵⁶ In fact, the Big Four had 39.1% of stock transactions, 72.1% of bond transactions, 64.3% in stock underwriting, 74.1% in bond underwriting, and almost 66% of pre-tax profits in 1990. The securities companies can thus be classified into three major groups: the Big Four, a handful of integrated companies, and a large number of small firms that are highly specialized in stock brokerage.¹⁵⁷

This cartel-like environment started to change in 1972 with the entry of major foreign securities firms into the securities market. Foreign firms were first allowed to obtain securities licenses in 1972.¹⁵⁸ By 1984, there

148. Suto, *supra* note 139, at 168.

149. SECURITIES MARKET, *supra* note 142, at 18.

150. Suto, *supra* note 139, at 168.

151. *Id.*

152. *Id.* at 180.

153. *Id.* at 181.

154. Noboru Tanabe, *Japan's Investment Trust: A Vehicle of Savings for Tomorrow*, 2 IND. INT'L & COMP. L. REV. 385 (1992).

155. Suto, *supra* note 139, at 169.

156. *Id.* at 175.

157. *Id.*

158. *Id.* at 178.

were ten foreign firms operating in Japan. As of March 1991, there were fifty-two foreign firms operating in Japan, twenty-five of which were members of the Tokyo Stock Exchange.¹⁵⁹ Despite a few exceptions on direct sale transactions, only securities firms may market securities products in Japan.¹⁶⁰ Under Article 2(8) of the Securities and Exchange Law, a U.S. mutual fund is classified as a foreign security, and, as such, is subject to the provisions of the Securities and Exchange Law.¹⁶¹ Since foreign securities firms generally lack retail networks in Japan, foreign investment trust management companies must market their products through Japanese security firms. These firms typically are the parent companies of Japanese investment trusts. As such, for all practical purposes, U.S. mutual fund companies must employ competitors if their products are to reach a broader investing public.¹⁶²

B. *The Japanese Investment Trust Management Business*

The Japanese investment trust management business, like the securities business, was traditionally shielded from foreign competition. As such, these funds initially experienced phenomenal growth, but recently have suffered the effects of not conforming to the western world of disclosure. Unlike their American counterparts, Japanese investment trusts have experienced a four-year decline in size and annual return.¹⁶³ This decline has been attributed to the Japanese investment trust industry's reluctance to construct a useful data

159. *Id.*

160. Securities and Exchange Law (Law No. 25), ch. 5, art. 81 (Apr. 13, 1948, as amended to June 9, 1981) (Japan) [hereinafter Japanese Securities and Exchange Law]. Article 81 provides, in pertinent part, that "no securities exchange may be established by any person other than securities corporations." *Id.*

161. *Id.* at art. 2(8). The rule provides that securities or certificates issued by foreign countries or foreign juridical persons constitute securities referred to in the Securities and Exchange Law. *Id.*

162. Japanese Securities and Exchange Law, *supra* note 160, art. 2. The Japanese Securities and Exchange Law originally contained no provision that controlled distribution of foreign shares in Japan. Since 1971, however, the foreign securities or certificates have been defined as "securities" under Article 2, and, as such, may only be exchanged by licensed securities corporations pursuant to Article 81. Under the agreement reached between the United States and Japan on January 10, 1995, greater opportunities for the retailing of investment trust products were created. Specifically, Japan confirmed that "securities subsidiaries of commercial banks are permitted to sell investment trust products, and that investment trust management companies are permitted to sell such products directly . . ." JOINT STATEMENT ON THE UNITED STATES-JAPAN FRAMEWORK FOR A NEW ECONOMIC PARTNERSHIP, MEASURES BY THE GOVERNMENT OF THE UNITED STATES AND THE GOVERNMENT OF JAPAN REGARDING FINANCIAL SERVICES 12 (1995) [hereinafter JOINT STATEMENT] (on file with IND. INT'L & COMP. L. REV.).

163. Sterngold, *supra* note 14.

base for comparing the funds' present performance to their past performance.¹⁶⁴ Japanese investors have been expected to invest on faith and not knowledge. This situation of blind investment will reverse when Japanese nationals have access to the same type of information that American and other foreign investors have at their disposal. The top fifty Japanese-managed open-end funds investing in the Tokyo stock market underperformed foreign-managed funds of Japanese stocks by an average of four points a year from 1987 to 1992.¹⁶⁵ Despite today's gradual emergence of foreign competition into the marketplace, the status quo of limited competition has been preserved by regulatory licensing and brokerage requirements which in practice have frustrated U.S. attempts at entry.

Equity mutual funds, known in Japan as "stock investment trusts," began operation in Japan in 1951 with the passage of the Securities Investment Trust Law.¹⁶⁶ This law exclusively governs Japan's domestic investment trust business. American firms that acquire a license for brokering their investment trust products are also governed by this law. The investment trust products of U.S. firms without a license in Japan fall within the purview of the Securities and Exchange Law and are defined as FITS. As a result, licensed securities firms—oftimes a competitor—must be employed to market them under the SEL.

Originally, securities companies carried out the management operations of investment trusts jointly with other business. In order to maintain the independence of the management of entrusted assets, securities companies separated and assigned the management operations to securities investment trust management companies after 1960.¹⁶⁷

Like its securities business, Japan's investment trust management business during modern history was resistant to competition. In contrast to the United States, where a foreign firm can enter the mutual fund business through straightforward registration with the SEC at modest cost, Japan has what amounts to significant regulatory barriers to entry. In guarding the industry, the MoF

164. *Id.* Investment philosophies, investments owned, and past yields are not information disclosed by the investment trust management company. However, this situation will change pursuant to an agreement reached between the United States and Japan announced on January 10, 1995. JOINT STATEMENT, *supra* note 162. Pursuant to the agreement, the Japanese have made a commitment to move toward market value accounting for personal liability calculations and disclosure of fund manager performance on a market value basis. *Id.* at 12-13. Further, Japan will "require investment trust management companies to enhance disclosure of investment trust products by amplifying the contents of the prospectuses and regular reports on an annual basis" *Id.* at 13. The enhanced disclosure is intended to assist investors in making investment decisions by providing them with detailed information on such matters as investment policy, dividend distribution policy, risk profiles, asset allocation, and fees. *Id.*

165. Gale Eisenstadt, *Self-inflicted Wound*, FORBES, Oct. 26, 1992, at 226.

166. YOSHIO SUZUKI, THE JAPANESE FINANCIAL SYSTEM 88 (1992).

167. *Id.* at 239.

has imposed a discretionary licensing system. This system has led to the formation of only twenty foreign investment trusts management companies as of February 1992.¹⁶⁸

In obtaining a license from MoF, investment trusts must demonstrate they have had average assets under management of no less than Y 300 billion over the most recent three year period, have marked a positive current balance for the latest period, be incorporated in Japan if an investment trust management company, and maintain net assets of no less than Y 50 million.¹⁶⁹ Because the SEL is inapplicable to investment trusts originating in Japan, the Securities Investment Trust Law stipulates that the management companies must prepare an explanatory statement in lieu of a registration statement.¹⁷⁰ This statement must be given to prospective subscribers. The companies must also prepare a financial report on the trust fund to be given to each certificate holder at the end of each fiscal year.¹⁷¹ In terms of investment scope,

[t]he concrete criteria for holdings of securities are set forth in the trust deeds and self-regulatory rules of the Investment Trusts Association. . . . Domestic bonds and debentures . . . may be held in the portfolio. All domestic stocks listed on securities exchanges and traded on over-the-counter markets . . . can be held.¹⁷²

Investment trusts of the open type may acquire no more than five to ten percent of the stock of any single issuing body.¹⁷³ In fact, the mainstay investment trust is designed as a financial product with low risk and strong savings orientation.¹⁷⁴ In many ways, the Japanese investment trust resembles a deposit because of its safety and expected rate of return.

"The total net assets of investment trusts reached a record high of Y 58.6 trillion at the end of December 1989."¹⁷⁵ Net assets have decreased considerably since the beginning of 1990, largely because the stock market has been depressed and stagnant, giving rise to capital outflows and the devaluation of portfolio stock.¹⁷⁶

[N]et assets plunged to the recent [low] of Y 38.5 trillion at the end of April 1992. . . . Under the impact of falling stock prices, the performance of some stock investment trusts was [so poor]

168. Tanabe, *supra* note 154, at 397.

169. JOINT STATEMENT, *supra* note 162, at 11-12.

170. Tanabe, *supra* note 154, at 397.

171. NAT'L SEC. DEALERS' ASS'N, STANDARDS OF SELECTION OF FOREIGN INVESTMENT TRUST SECURITIES (Resolution of the Board, Nov. 20, 1972) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter STANDARDS].

172. INVESTMENT TRUSTS, *supra* note 129, at 22.

173. *Id.* at 24.

174. Tanabe, *supra* note 154, at 395.

175. INVESTMENT TRUSTS, *supra* note 129, at 4.

176. *Id.*

that their net asset values fell below the par value at the time of redemption. . . . On the contrary, the net assets of bond investment trusts increased steadily, because their characteristic of maintaining stable incomes appealed to investors. . . . All in all, the total net asset value of all Japanese investment trusts recovered to Y 43.5 trillion at the end of March 1993.¹⁷⁷

C. *Regulatory Environment for Foreign Domiciled Funds Sold in Japan*

Despite reforms in 1993 and recent confirmation by the government of Japan that subsidiaries of commercial banks are permitted to sell investment trust products,¹⁷⁸ Japanese banks have not matured to the point where they can be considered a viable retail distribution channel by U.S. Mutual Funds.¹⁷⁹ Modeled on the U.S. Glass-Steagall Act, Article 65 restrictions of the Securities and Exchange Law traditionally precluded banks from engaging in the securities business except for government and public securities.¹⁸⁰ Japanese banks are therefore not considered a distribution channel for American mutual funds. As such, U.S. mutual funds are forced to make an entry into the Japanese financial economy *de novo* by acquiring the proper licenses, or tolerate their products being sold by their competitors. To date, only five U.S. funds, among them Keystone and Dreyfus,¹⁸¹ have been able to overcome the onerous regulations placed upon them. However, expansion in the investment trust market by foreign players could parallel foreign expansion into the securities market because of the MoF's current reform-orientated posture.

The Japanese investment trust market historically has been closed to foreign investment products by a Japanese monetary policy aimed at minimizing capital outflows. The MoF hesitated to lift restrictions on foreign investment trust securities because it felt a need to: "(1) harmonize the legal treatment of domestic trusts with that of foreign trusts established under a variety of legal regimes; and (2) consider measures for investor protection, given the differences between foreign trust securities and listed foreign securities" ¹⁸² The gradual opening of the Japanese market to foreign domiciled

177. *Id.* at 4-5.

178. JOINT STATEMENT, *supra* note 162, at 12.

179. At a maximum, a bank has been able to sell securities for its own portfolio investment or underwrite government bonds, local government bonds, and government guaranteed bonds. The Banking Law, art. 10, § 2(2), (4) (1981) (Japan).

180. Japanese Securities and Exchange Law, *supra* note 160, art. 65.

181. The other three are Federated, Fidelity, and Allied. GEORGE CURUBY, SELLING OFFSHORE MUTUAL FUNDS IN JAPAN I-14, I-16 (Curuby & Co. 1993) [hereinafter OFFSHORE MUTUAL FUNDS] (on file with IND. INT'L & COMP. L. REV.).

182. *Id.* at 49.

investment trusts in 1973 was preceded by a period of liberalization of Japanese controls during the 1960's and early 1970's.¹⁸³ The first steps that set the stage for this process were taken in 1964 when Japan eased foreign exchange restrictions over current transactions and concurrently participated in the OECD Code of Liberalization of Capital Movements.¹⁸⁴

The liberalization measures enabling investments in foreign domiciled trusts by Japanese Nationals included provisions for both open-end and closed-end trusts.¹⁸⁵ The measures aimed to loosen restrictions on Foreign Investment Trusts (FITS) "and to provide for their integration into Japan's Securities and Exchange Law."¹⁸⁶ As a result, FITS are defined as foreign securities by a Ministry Ordinance rather than the Japanese domestic Securities Investment Trust Law. As foreign investment trust securities, they must file a securities registration statement and a securities notice.¹⁸⁷ Further, because the only type of investment trusts that can be created and sold in Japan are *securities* investment trusts, the distribution and administration of investment trust beneficiary certificates can only be handled by securities companies licensed by the MoF.¹⁸⁸ The management companies themselves are not able to sell and redeem their funds/trusts directly or through affiliates unless they use an affiliate with a broker's license.

"The first foreign investment trust sold as a public offering was the U.S.-domiciled 'Dreyfus Fund,' distributed by Daiwa Securities in January 1973."¹⁸⁹ From 1974 to 1982, "only [twelve] additional foreign trusts were publicly offered due to a Japanese monetary policy aimed at minimizing capital outflows"¹⁹⁰ From 1983 to 1985, twenty-one new foreign trusts were publicly offered in Japan, thereby bringing the total to forty trusts.¹⁹¹ By 1987, there were a total of eighty-two publicly offered foreign investment trusts in Japan with assets of \$6.4 billion.¹⁹²

"At the end of September 1993, there were 5,943 total securities investment trusts in Japan accounting for Y 47.5 trillion (about \$430 billion) in assets."¹⁹³ As of June 1993, there were 247 publicly offered offshore funds/investment trusts

183. *Id.*

184. *Id.*

185. *Id.* at 50.

186. *Id.*

187. OFFSHORE MUTUAL FUNDS, *supra* note 181, at 57 (citing MINISTRY OF FINANCE, Ordinance No. 78 (Nov. 18, 1972) (Japan)).

188. OFFSHORE MUTUAL FUNDS, *supra* note 181, at 61.

189. *Id.* at 45.

190. *Id.*

191. *Id.*

192. *Id.* at 46.

193. INVESTMENT TRUST MANAGEMENT, *supra* note 11.

in Japan with an outstanding \$6.4 billion in net assets held by Japanese investors.¹⁹⁴

On an annual new fund sales basis, the public offering of offshore funds peaked in 1989 with 43 new funds totaling \$2.8 billion. This declined to 38 funds worth \$1.9 billion in 1990, 19 funds worth \$660 million in 1991, 14 funds worth \$540 million in 1992, and 6 funds worth \$330 million in the first half of 1993. On an aggregate outstanding NAV basis, offshore funds publicly offered reached their zenith at the end of March 1991 at \$9.2 billion. Since 1991, total assets invested in investment trusts has been decreasing.¹⁹⁵

The decline resulted from:

- (1) an overall decrease in investments by Japanese residents and problems with financial institutions;
- (2) the appreciation of the yen which has outpaced . . . the performance of most funds during the period;
- (3) the establishment of foreign-affiliated mutual fund firms in Japan; and
- (4) the lackluster Japanese stock market, which has led both Japanese and onshore foreign mutual fund operators to create a large number of domestic trusts specializing in offshore investment.¹⁹⁶

Foreign-owned investment trust management companies recently were allowed to compete directly with Japanese investment trust management companies by becoming eligible for licenses, rather than just have their products sold, in the Japanese market.¹⁹⁷ This quiet reform is probably the result of investor intolerance of what will become past investment trust practices. Further, Japanese investment trusts have performed poorly when compared to the risk-adjusted market return. The reasons for the poor performance include high transaction costs, government regulations on fund activities, and lack of competition.¹⁹⁸ Consequently, investors withdrew a net ¥ 2.8 trillion from stock-investment trusts in the first nine months of 1993.¹⁹⁹

194. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-1.

195. *Id.*

196. *Id.*

197. Tanabe, *supra* note 154, at 411 (Report by the Study Group on Investment Trusts, Securities Bureau of the Ministry of Finance (1988)). "As of January, 1992, four foreign-affiliated financial companies have been approved to get a license to establish investment trust management companies." *Id.* at n.42.

198. Junko Maru, *The Structure and Performance of Investment Trusts in Japan*, in JAPANESE CAPITAL MARKETS 489 (Shinji Takagi ed., 1993).

199. *Punting*, *supra* note 12.

D. *U.S. Mutual Fund Procedure in Japanese Market Entry*

The primary impediments to U.S. mutual fund entry into the Japanese investment trust business have been licensing, costs of entry, and distribution problems. Although the minimum capital requirements for license eligibility have been reduced, other costs associated with licensing and registration have raised questions about the commercial viability of foreign mutual fund management companies. Additionally, the application and approval process is highly subjective, which invariably makes U.S. competitors reluctant to expend the efforts abroad while business has been rewarding at home. In recent years, however, the MoF has made reforms designed to attract U.S. and other foreign fund companies.

Because beneficiary certificates of foreign mutual funds are defined as securities under the Japanese Securities and Exchange Law, they are subject to securities industry regulations.²⁰⁰ When a company makes public offerings of mutual funds, those which are offered to fifty or more investors on equal terms and conditions for a specified period of time, a securities registration statement and a foreign registration statement with the MoF must be filed.²⁰¹ "The documentation and filing of a public offering entails costs ranging from \$50,000 to \$100,000, depending on the offshore domicile and whether the fund is already in operation. . . . From initial discussions to actual launch takes 2-3 months."²⁰² Private placements of FITS, those offered to between fifty and 500 institutional investors on equal terms, are required to file a less onerous Securities Notice instead of a registration statement.²⁰³ A registration statement becomes necessary, however, if the fund is offered to more than 500 qualified institutional investors.²⁰⁴ The notification process may require full explanation to the MoF regarding "funds with esoteric or high risk investment goals."²⁰⁵ The funds also must appoint a designated broker as sales agent in Japan.²⁰⁶ Since the paperwork is not as great as public offerings, the associated costs are lower, and the whole process may be completed in a six-week period.²⁰⁷

200. Japanese Securities and Exchange Law, *supra* note 160, art. 2(1)(vii). In contrast, the Securities and Exchange Law does not, at present, apply to domestic investment trusts. Ichiro Kawamoto, *Investment Trusts*, in JAPANESE SECURITIES REGULATION 209, 221 (Lewis et al. eds., 1983).

201. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-3.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.* at I-4.

206. *Id.* at I-3.

207. *Id.* at I-4.

In addition to filing with the MoF, foreign investment trusts that sell to fifty or more persons, not necessarily Japanese nationals, within a six-month period also must file a registration statement with the National Securities Dealers Association (NSDA) for disclosure purposes.²⁰⁸ In addition to the Securities and Exchange Law requirements, publicly offered FITS must conform with guidelines administered and enforced by the NSDA.²⁰⁹ Ironically, the NSDA is *not* involved with private placements.²¹⁰

All U.S. mutual fund companies, known as "Trust Managers," must be licensed before they can organize mutual funds in Japan.²¹¹ Until recently, portfolio managers, known as "Discretionary Investment Advisers," also were required to acquire a separate license, despite being in a complementary business.²¹² Licenses are granted on a discretionary basis, which gives broad powers to regulators by a subjective and wholly non-transparent registration process. Each license requires a separate capitalized local entity, with distinct office space and staff.²¹³ Further, while a local entity may accept advice

208. NAT'L SEC. DEALERS ASS'N, DISCLOSURE GUIDELINES FOR FOREIGN INVESTMENT TRUSTS, (Hideki Maedemari trans., Mar. 15, 1994) (Japan) (on file with IND. INT'L & COMP. L. REV.). Information furnished by Mikasa Law Office, Tokyo, Japan.

209. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-3. The principal regulatory provisions are: "(a) MoF Ordinance of 1972 regarding public offerings of FITS; (b) Standards of Selection of FITS of the JSDA; (c) Regulations concerning the trading of Foreign Securities; (d) certain provisions of the Securities Exchange Law and the Foreign Exchange Control Law." *Id.*

210. *Id.*

211. Securities Investment Trust Law, ch. 2, art. 6 (Law No. 198, June 4, 1951) (Japan) [hereinafter Trust Law].

212. Pursuant to an agreement reached between the government of the United States and Japan on January 10, 1995, Japan now will only "permit a discretionary investment management company to conduct, in one entity, investment trust business and discretionary investment management business," as well as investment trust management. JOINT STATEMENT, *supra* note 162, at 10-11. To be eligible to obtain a dual function license, a company must:

- 1) have had average assets under management of no less than 300 billion yen over most of the recent three year period; in case of a foreign discretionary investment management company in Japan, such assets will be the average assets under management by the parent company of such company; and
- 2) have marked a positive current balance for the latest period; in the case of a company that has a marked negative balance, under special circumstances, it is still eligible if it marked a positive balance under any of the three most recent periods.

Id. at 11. Further, an investment trust management company must be incorporated in Japan.

Id. at 12. Lastly, Japan will "remove the current minimum capital requirement . . . of 300 million yen . . . and replace it with the requirement that an adequate amount of capital be prepared to maintain net assets of no less than 50 million yen" *Id.*

213. Any company desiring to obtain the license shall file an application for the license which shall include the following information: (1) the corporate name and the amount of capital; (2) the names and locations of the principal office, branch offices and other places of business;

from its U.S.-based parent, all portfolio transactions must be executed in Japan.²¹⁴ U.S. Funds without brokerage licenses must sell their products through licensed securities brokers.²¹⁵ Foreign firms must pay a "loyalty fee" of up to 0.6% to the brokerage house each year the trust remains operational.²¹⁶ "The brokers also take a two percent front-end commission from the investors."²¹⁷ Therefore, foreign fund operation costs could run three to four times higher than necessary.²¹⁸

The biggest initial obstacle to opening up Japan's market to foreign participation is cost.²¹⁹ A centrally-located office, with one broker and one secretary, will cost about \$350,000 to \$400,000 per year to operate.²²⁰ This amount of money will be required for a minimum of five years if the company is previously unknown in Japan.²²¹ The staffing requirements are also a problem.²²² The subsidiary of any foreign company should be run by a person from the head office.²²³ Foreign companies have great difficulty in persuading their best executives to spend five years in Japan.²²⁴

Article 7 of the Securities Investment Trust Law contains the requirements for a Japanese investment trust management company license.²²⁵ Prior to approval, each application for a license is reviewed by the MoF and judged in conformance with three basic criteria. The applicant must first be "sufficiently qualified to engage in the management of securities investment trusts, after being evaluated in the light of its personnel structure, experience in and ability to invest in valuable securities."²²⁶ Secondly, the applicant's "prospects related to the income and expenditures of [its] business . . . [must be] sufficiently

and (3) the full names of the directors. *Id.* The actual requirement of separate office space and staff is derived from administrative, and not legislative, guidance. Currently, a total of about 30 people is considered standard. MINISTRY OF FINANCE, REVIEW OF THE STANDARDS FOR THE LICENSE FOR THE INVESTMENT TRUST MANAGEMENT BUSINESS 3 (Jan. 28, 1992) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter REVIEW].

214. U.S.-JAPAN BUSINESS COUNCIL, *supra* note 132, at 15.

215. Foreign investment trusts are banned from directly selling to Japanese nationals. Fingleton, *supra* note 13.

216. *Id.*

217. *Id.*

218. *Id.*

219. U.S. DEP'T OF THE TREASURY, Japan Office, EMBASSY OF THE U.S., INTERNAL MEMORANDUM ON INVESTMENT TRUST MANAGEMENT COMPANIES, (Mar. 22, 1991) (on file with IND. INT'L & COMP. L. REV.) [hereinafter INTERNAL MEMORANDUM].

220. *Id.*

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

225. Trust Law, *supra* note 211, art. 7.

226. *Id.* art. 7(1).

bright."²²⁷ Lastly, the "applicant's business as a management company [must be] necessary and appropriate in light of the existing condition of the securities investment trust business and the securities market."²²⁸ With the exception of these highly subjective legislative controls, the remainder of the licensing process relies largely upon administrative guidance.

The MoF issued guidelines on December 14, 1989, for the licensing of foreign investment trusts.²²⁹ Pursuant to these guidelines, the granting of licenses to the first foreign-affiliated firms took place in 1990.²³⁰ In response to the requests of other advanced nations, the MoF again reviewed its regulations in January 1992. "Amendments to these guidelines were subsequently announced on January 28, 1992."²³¹ While the MoF believed the current licensing standards should employ a more liberal standard and should approve more entities to promote fair competition, the MoF was adamant that a fire wall develop between the activities of the parent and the applicant firm in cases where the parent company engages in business other than the asset management business.²³² The purpose of such a wall was to prevent abuses after entry into the market.²³³

The 1989 guidelines provided that the applicant firms must have at least three consecutive years of investment trust experience and, among foreign firms, expressed preference for those with experience selling their offshore funds in Japan.²³⁴ Licensing prerequisites, such as experience in the Japanese investment trust business, were dropped by the 1992 amendments, however, for parent bodies which had achieved a certain scale of results in their home country and which could be expected to attain the same results in Japan.²³⁵ In 1989, a total of about thirty persons, including directors, was considered standard for setting up an investment trust company. Following the 1992 amendments, this requirement was dropped.²³⁶ Similarly, applicant firms now can be jointly established by several companies instead of by a single parent company. The investment trust management company formerly was required to have a paid-in capital of Y 300 million and an ongoing net worth

227. *Id.* art. 7(2).

228. *Id.* art. 7(3).

229. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 15.

230. *Id.*

231. *Id.*

232. REVIEW, *supra* note 213, at 1.

233. *Id.*

234. GUIDELINES, *supra* note 130; *see also* INVESTMENT TRUST, *supra* note 11, at 15.

235. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 15.

236. REVIEW, *supra* note 213.

of at least Y 50 million, and it must show a business profit after three years of operation (or after five years for foreign-affiliated firms).²³⁷

Sales forecasts sufficient to support business operations will be judged for foreign applicants based on their business record in their home country, concrete sales tie-ups with Japanese firms, and their prior success of selling offshore funds in Japan. In principal, directors must be full time employees, and the [investment trust management companies] must maintain separate offices. Personnel must have experience in the investment trust business, and the staff size must be considered adequate by [the Ministry of Finance].²³⁸

Following the adoption of measures by the governments of Japan and the United States regarding financial services, foreign investment trust management companies are no longer required to show paid-in capital of Y 300 million or an extended record of profit. It follows that Japanese Investment Trust will be less impervious to foreign competition as more foreign firms will likely be able to satisfy the entry requirements.

Other guidelines, until recently, have been equally restrictive. When the transactions are executed, they must conform with rigid asset allocation guidelines. Specifically, the NSDA guidelines provide that: the assets of the fund may not be used for underwriting or short sales of securities; that the fund may not borrow an amount beyond ten percent of its assets; may not invest more than ten percent of its assets in the stocks of one issuer or in other investment trust securities or in securities with low liquidity; and may not invest in commodities or real estate.²³⁹ These legal guidelines on asset mix limited the free flow of capital and made it virtually impossible to construct truly efficient portfolios. Such guidelines also restrict the possibility of specialist management, an approach that is accepted in most other markets and is generally believed to yield better returns. Consequently, institutional Japanese funds were virtually assured suboptimal performance.²⁴⁰

237. DEP'T OF THE TREASURY, EMBASSY OF THE U.S., UNCLASSIFIED INFORMATION RELEASE (1992) (Japan) (on file with IND. INT'L & COMP. L. REV.) [hereinafter RELEASE].

238. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 15.

239. STANDARDS, *supra* note 171.

240. However, under the new agreement reached between the United States and Japan, investment trust management companies will have more flexibility in choosing investments. JOINT STATEMENT, *supra* note 162. Specifically, "the government of Japan will permit investment trust management companies to invest up to but not including 50% of each fund in institutions other than those defined under Article 2 of the [SEL]." *Id.* at 13. Such companies may now invest in yen CD's, yen call money, and securitized real property. *Id.* Japan will "fundamentally deregulate current restrictions on the types of instruments in which funds will be allowed to

E. *Impact of these Regulations on the Entry of U.S. Mutual Funds*

Although the January 1992 amended guidelines reduced the minimum capital requirement from Y 500 to Y 300 million (\$2.9 million), the minimum net worth requirement of Y 50 million (\$490,000) critically restrained entry into the Japanese market.²⁴¹ These guidelines created operational, as opposed to legal, constraints on effective competition. By contrast, the United States only requires \$100,000 of capital per individual mutual fund,²⁴² nearly a thirty to one ratio. The minimum capital requirement actually constrains U.S. company entry more than the minimum net worth requirement since foreign investment trust management companies (ITMC) must post a profit within five years of entry. Past new entrants in Japan could easily exhaust Y 300 million of capital from the time of start up to profitability, making it all the more difficult to maintain a minimum net worth of Y 50 million at all times. The MoF responds to criticism by saying that the U.S. mutual fund industry fundamentally differs from Japan's. In Japan, initial capital contributions support the ITMC, whereas in the United States, each individual fund represents a separately capitalized corporation.²⁴³ Foreign investment adviser companies have no minimum capital requirement in the United States.²⁴⁴ As such, either the adjusted minimum net worth requirements or the merger of the ITMCs and Investment Advisers' licensing process should inspire new, lower-cost entry into the Japanese market.²⁴⁵

The requirement that only qualified securities companies can serve as distribution agents for offshore mutual funds has created a marketing problem, which in turn may dissuade entrance by U.S. mutual fund companies. The broker class is limited to Japanese brokers and foreign brokers who have a branch license and who have applied to the Japan Securities Dealers Association for authorization to sell FITS. Distributors place their greatest effort on selling

invest in" *Id.* Accordingly, the requirement that futures and options trading be used only for hedging is abolished, and the permissible range of margin transactions in which stock may be borrowed and sold will be expanded. *Id.* at 13-14. Additionally, investment trust management companies are allowed to invest in foreign and domestic privately placed bonds, other investment trust products, and securitized investment backed by real property. *Id.* at 14.

241. U.S. DEP'T OF TREASURY, ASSET MANAGEMENT (INVESTMENT TRUSTS) (May 1994) (on file with IND. INT'L & COMP. L. REV.) [hereinafter ASSET MANAGEMENT].

242. 15 U.S.C. § 80a-12(a)(1). This section provides that no registered investment company shall make a public offering of securities of which such company is the issuer, unless: such company has a net worth of at least \$100,000.

243. ASSET MANAGEMENT, *supra* note 241.

244. 15 U.S.C. 80b-1 to 80b-21. The Investment Advisers Act of 1940 has no minimum capital requirements for the application of an investment adviser license.

245. ASSET MANAGEMENT, *supra* note 241.

domestically-created trusts and only sell foreign-domiciled trusts as an occasional means of "rounding out" their product line. There are fewer distributors than funds, so securities brokers generally form relationships with those foreign funds that pay the highest commissions and share their investment expertise. Most foreign management firms only have relations with the international departments of Japanese brokers, while it is the domestic investment trust sales departments that actually sell these foreign trusts in Japan. There is also a disruptive MoF guideline which applies to publicly-offered foreign funds in Japan. The guideline requires that an amount equal to twenty percent of the value of the Japanese offering must be placed outside Japan.²⁴⁶ This guideline is burdensome because many brokers cannot place this amount with certainty and the investment objectives of funds specifically designed for Japanese investors are often not suited for other foreign investors.²⁴⁷

Brokers are further hindered by the prohibition on implementation of special sales charge systems, such as special discount, "no-load," or "front-end load."²⁴⁸ The brokerage commission is strictly regulated to a maximum of 180 basis points. "The MoF [also] does not permit the management company and the broker to agree on a commission between them."²⁴⁹ Additionally, "the upper limit is too low to permit commission splitting arrangements where more than one [agent] may be involved."²⁵⁰

In addition to the legal barriers to market entry, exclusionary structural impediments confront U.S. money managers who seek to enter the Japanese market. Historical practices and institutional structure have resulted in a concentrated, Japanese-exclusive financial market, according to a 1993 report by the U.S.-Japan Business Council. That report stated:

For example, in Japan there is no well-defined concept of fiduciary responsibility. In addition, there are no generally accepted standards for measurement of performance for investment managers. Finally, rigid asset allocation guidelines make it difficult, if not impossible, for investment managers to construct efficient portfolios. Consequently, fund managers are restricted in competing on the basis of performance. The effect of this system is to restrict competition from new entrants, domestic or foreign, and thus preserve the lucrative status quo for the small number of dominant firms. While the regulations and business

246. OFFSHORE MUTUAL FUNDS, *supra* note 181, at I-5.

247. *Id.*

248. STANDARDS, *supra* note 171.

249. INTERNAL MEMORANDUM, *supra* note 219.

250. *Id.*

practices are not targeted specifically at foreign firms, they have the effect of limiting the participation of foreign firms in this market.²⁵¹

The U.S. Treasury has negotiated on the topic of ITMC's for a number of years, and recently reached an agreement with Japan. In the course of negotiations, the Treasury proposed a number of changes that would help both foreign and domestic investment trusts operate more competitively in Japan. In particular, the life of funds is usually limited to five years with an upper limit of seven years. The result is investor perception that the trust is a stable, "savings-type" product and not an investment with a degree of risk — and reward. Eliminating the duration period would encourage more investors to invest. A burdensome cash reserve rule also requires sixty percent of any surplus above initial issue price to be set aside at each half and full year. Eliminating this rule would increase investor exposure to the equity market through more equity investments by the investment trust. Investment trusts also should be placed on equal footing with direct equity investment. Currently, investment trust profits are taxed at twenty percent when investors may choose to pay a one percent tax on private investment disposals instead.²⁵² Also, the investment trust management rules are absurdly complicated. "For example, the rules allow for up to [fifty percent investment] in "second section" stocks . . . and separately, [fifty percent] in over-the-counter . . . stocks. The rules do not say that together, these two categories may not exceed [fifty percent]. But this is the unwritten guidance."²⁵³

On January 10, 1995, the governments of the United States and Japan adopted Measures Regarding Financial Services under the Joint Statement on the Japan-United States Framework for a New Economic Partnership. The measures established under the agreement with respect to investment trusts are expected to increase sales and access of competitive foreign financial goods and services. This goal will be achieved through less burdensome licensing requirements, expansion of distribution channels for investment trust products, and a host of newly permitted investments. Further, the Japanese have agreed to enhance the disclosure of investment trust management performance data.²⁵⁴ This decision should intensify, at a minimum, the competition between Japanese Investment Trusts and ultimately lead to better returns. In the final analysis,

251. U.S.-JAPAN BUSINESS COUNCIL, *supra* note 132.

252. INTERNAL MEMORANDUM, *supra* note 219.

253. *Id.*

254. Investment Trust Management Companies must now enhance disclosure of investment trust products by amplifying the contents of prospectuses and regular reports on an annual basis in order that investors may make investment decisions based on more detailed information such as investment policy, dividend distribution policy, and risk. JOINT STATEMENT, *supra* note 162, at 13.

effectiveness of these measures should be easy to gauge by examining whether there is an increase of foreign ITMC presence as compared to pre-1995.

F. Japanese Bank Entry into the Investment Trust Management Business

On April 15, 1992, the MoF formally "announced that it would relax licensing and operational requirements for investment trust management companies."²⁵⁵ The MoF is now injecting competition into the investment trust business and has allowed five banks to manage funds.²⁵⁶ Prior to their entry in October 1993, all Japanese ITMCs were affiliated with a securities company and, in some cases, a major banking group through minority shareholding. The recently established bank-affiliated ITMCs have been created as subsidiaries of the investment advisory subsidiaries of the bank's group. These ITMCs carry the name of their parent company and are considered direct representatives of their group.²⁵⁷ Banks are still prohibited from acting as distributors of investment trusts. Due to the opposition of securities companies to banks selling investment trusts, Japanese Investment Trust expert George Curuby estimates "this restriction is likely to continue for at least the next three years."²⁵⁸

Many major investment trust management companies are hopeful that banks eventually will be allowed to distribute mutual funds in Japan because they expect this to broaden the mutual fund ownership by Japanese households. In the United States, about twenty-five percent of the population owns mutual funds, which account for about ten percent of household assets. In Japan, only ten percent of households own funds which account for about four percent of household assets. "Banks becoming distributors will be a positive factor for the industry."²⁵⁹

Despite years of pushing the MoF for deregulation, some banks are concerned that the investment trust management business will not be initially profitable. Furthermore, some Japanese bank institutions were unhappy with Ministry restrictions on the sale of investment trusts through their own large bank networks. As it stands now, non-securities firms which enter the market must manage the funds in a separate affiliate and enlist the help of Japanese securities houses, which hold exclusive rights on the direct sale of investment

255. RELEASE, *supra* note 237.

256. *Id.* The banks are not allowed to sell the funds through their branches, but must instead use brokers. INVESTMENT TRUST MANAGEMENT, *supra* note 11, at 3.

257. The five banks are Fuji Bank, Sanwa Bank, Sakura Bank, Sumitomo Bank, and Norinchukin Bank. *Id.*

258. *Id.*

259. *Id.*

trusts, to move the product.²⁶⁰ City Banks fear, however, that if they delay entry this time they may alienate the MoF, which is anxious for further financial industry deregulation, and will not get the "OK" when they feel they are ready. It is understood that the Ministry can cite any reason for refusing a license, such as "inadequate corporate performance" or "poor timing."²⁶¹

The entrance of the banks invariably comes in response to calls for reform. Of the 2,918 stock investment trust funds in Japan at the end of September 1993, 1,551 were below their initial value.²⁶² One cause for this decline has been the lack of an independent rating system. Although investors do receive performance information twice a year, they have difficulty obtaining information which compares the funds.²⁶³ Although the investment trust skills of banks are open to question, their entry heralds the start of competition between bankers and securities brokers. Where the investment trust subsidiaries of banks have three years to become profitable under the terms of their license approval, this intensified competition likely will produce a better performing investment trust product.

VI. CONCLUSION

"In 1992 . . . the Diet took a major step [in] bringing the Japanese financial system into closer alignment with other industrial countries."²⁶⁴ Although legislation has permitted carefully defined crossing over by most classes of financial institutions into each other's business, the reforms have amounted to less distinctions between financial institutions on paper than in actual practice.²⁶⁵ Article 65-3 now makes companies owned by banks eligible for a MoF securities license.²⁶⁶ Where the financial climate in Japan is maturing, an opportunity is present for U.S. mutual fund companies to penetrate the market and seize market share. The opening of the investment trust management business to banks reflects Japan's relaxing regulatory position.

260. Yas Idei, *City Banks Split on Investment Trusts*, Apr. 12, 1993, available at Embassy of the United States in Japan, Office of the Financial Attache (on file with IND. INT'L & COMP. L. REV.).

261. Tomohiro Akamatsu, *Four City Banks Reluctantly Move into Investment Trusts*, TOKYO BUS. TODAY, Dec. 1993, at 56.

262. Hiroyuki Nishomura, *Investment Trusts Probing for Reforms*, Oct. 25, 1993 (quoting the Investment Trust Association) (on file with IND. INT'L & COMP. L. REV.).

263. *Id.*

264. J. Robert Brown, Jr., *Japanese Banking Reform and the Occupational Legacy: Decentralization, Deregulation, and Decentralization*, 21 DENV. J. INT'L L. & POL. 361, 362 (1993).

265. *Id.*

266. *Id.* at n.6.

It follows that where the MoF has been responsive to foreign requests for change, and has responded accordingly with amended guidelines, the U.S. mutual fund industry immediately can impact the investment trust market. The U.S. funds should capitalize on their popularity and worldwide reputation while they have it—and domestic banks do not—to penetrate and capture the anticipated growth in the Japanese asset management business.

Internationalization of the investment trust market is a concomitant of internationalization of the Japanese economy. As the Japanese economy continues to expand internationally, so too will the securities industry — and invariably the investment trust business. The MoF has facilitated this internationalization through simplifying foreign investment trust access to its financial markets. Public offering of closed-end investment trusts are treated the same as foreign stocks in general and are not subject to the provisions of the ministerial ordinance. Conversely, foreign open-end investment trust funds in Japan are regulated by the "Ministerial Ordinance Concerning Disclosure of Issuers of Foreign Investment Fund Shares." If the open-ended investment trust meets the "Standard Rules for the Selection of Foreign Investment Trust Funds to be Sold in Japan,"²⁶⁷ the foreign approval to sell to Japanese nationals soon will follow.

Since the turn of the decade, investment trusts have faltered and suffered from the fall in stock markets.²⁶⁸ As a consequence, the value of their net assets has decreased precipitously.²⁶⁹ Japanese stock funds have performed badly, due in part to affiliates of the four largest brokers controlling about seventy percent of the fund market.²⁷⁰ In response to the trusts' poor performance, the Japanese Finance Ministry has tried to compensate investors by extending the investment trusts' redemptive period.

When compared with American mutual funds that invest in Japanese companies, the Japanese Investment Trust would be hard-pressed to compete. A preliminary analysis of these funds tracked for the first quarter of 1994 revealed gains of 17.3%.²⁷¹ This statistic alone should encourage, at a minimum, the managers of those Japanese Equity and OTC funds to pursue opportunities with Japanese nationals. Mutual funds and mutual fund managers must consider the Japanese as a source of revenue because it has become increasingly difficult to compete for domestic dollars. Where American funds do very well investing in Japanese companies, they could probably charge a load in Japan and still be competitive. With the U.S. Treasury's recent agreement easing the regulatory framework, the investment trust management

267. INVESTMENT TRUSTS, *supra* note 129, at 47.

268. *Id.* at foreword.

269. *Id.*

270. Eisenstodt, *supra* note 165.

271. Eric J. Savitz, *Losing Ground, Keeping Calm*, BARRON'S, Apr. 4, 1994, at 25.

industry in Japan has advanced to the point where it makes commercial sense for foreign mutual funds to compete there.

If the evolution of the investment trust selling activity of the Japanese bank subsidiaries in any way parallels the success U.S. banks have enjoyed with their involvement in mutual funds, U.S. Mutual Funds will enjoy immediate success. First Union Bank "forecasts that it will grow a current \$3 billion in mutual fund assets under management into \$25 billion within five years."²⁷²

Overall, the banks' mutual fund assets have risen sixfold since 1987, to \$180 billion. In 1993, banks accounted for sixteen percent of all mutual fund sales.²⁷³ On present trends, the U.S. mutual fund industry will become the principal repository for U.S. money. At the end of 1993, mutual funds comprised eighty-one percent of commercial bank deposits, compared with about ten percent in the early 1980's.²⁷⁴ Total assets in mutual funds has doubled in just three years through the capturing of domestic dollars. This expansion could easily continue into Japan, where investors are starved for a premium investment trust. It can no longer be said that the incentive for entry has been lost in the translation.

272. *Id.*

273. *The Bottom Line*, *supra* note 7.

274. *Id.*

