

THE REGULATION OF FINANCIAL MARKETS*

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Abstract

This Address shows in some specific detail how the model developed in Stigler's 1971 classic paper, "The Theory of Economic Regulation" can explain many of the regulatory policies of the Japanese Ministry of Finance; and also why many of those policies have persisted in the face of their complete, abject and in some respects humiliating failures to meet their announced objectives. Comparisons and contrasts with U.S. financial market regulation are also made.

Thirty years ago my late, and much missed friend and colleague, George Stigler, fired the opening shot in what has become a revolution in the economic theory of regulation. The shot was aimed at the U.S. Securities and Exchange Commission—that jewel in the crown of reform agencies created by the Roosevelt Administration in the 1930's in response to the supposed financial excesses of the 1920's. After noting the substantial volume of new regulations the SEC had introduced in its 30 years, Stigler asked the following, somewhat startling question: What empirical evidence has the SEC ever provided to show that its regulations accomplished their announced public policy objectives?

No evidence at all, said Stigler, who thereupon undertook some empirical research studies that the agency, with its vastly greater resources *should* have done either before the regulations and their attendant costs were imposed on the public; or, if that was not practical, after the regulations had been in force long enough to measure the benefits produced.

That Stigler could find no evidence of social benefits for the specific regulations he studied posed even more puzzling and disturbing questions. Why does a regulatory agency keep imposing regulations that don't seem to produce as promised. The people running the regulatory agencies are not stupid, after all. Can it be that their regulations really *are* working, but are actually accomplishing objectives very different from those advertised?

Stigler followed up that thought with a number of subsequent papers culminating in his justly famous 1971 paper entitled "The Theory of Economic Regulation." That classic paper is the foundation on which the modern theory of regulation has been erected not only in economics, but in law and in their lively joint offspring, the spectacularly growing field

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of law and economics.

The many examples Stigler introduced to illustrate propositions and predictions of the economic theory of regulation were drawn, understandably, from American regulatory experience. But on rereading his paper once again, soon after receiving Professor Shimizu's invitation to serve as Keynote Speaker for this Symposium, I was struck by how aptly the reasoning applied to *Japanese* regulatory experience, especially the financial regulation maintained by the Japanese Ministry of Finance (hereafter, MOF). The fit was tailor-made, amazingly so, since to my knowledge, Stigler had no first-hand knowledge of what MOF was up to.

What I propose to do today is an out-of-sample prediction of Stigler's model, as it were (the only kind of empirical work one can really trust), by showing in some specific detail how Stigler's economic theory of regulation can explain MOF's policies; and can explain also why those policies have persisted in the face of their complete, abject and in some respects humiliating failures to meet their announced objectives.

1.0 *The Theory of Regulation*

Let me begin with in what in some ways was Stigler's most fundamental contribution, namely transferring the economic theory of regulation from normative, to positive economics. Specifically, he assigns the theory of economic regulation the task not of listing the many possible sources of market failure (like monopoly or asymmetric information or externalities) along with neat schemes of taxes and subsidies to achieve first-best, or second-best solutions but the task of explaining and I quote him, "who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources" (p. 5). And in his 1971 paper, Stigler takes the central insight of that new positive theory to be, again to quote him, that "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit" even though the regulation might initially have been thrust on the industry against its opposition (p. 5).

Stigler acknowledges the possibility that some regulations may exist whose net effects are onerous. But he regards these as rare, and as explainable by the same theory, just pushed one or two layers deeper. I'll present later, in due course, some examples, both Japanese and American, of these seeming exceptions to the industry-benefit presumption.

Let me also hasten to say that I will be talking about Stigler's 1971 paper which got the field started and which stimulated so much further academic research on the positive theory of regulation. The 1971 paper, with its oft-called "capture theory of regulation," has aged surprisingly well in my view, but it has been substantially expanded and broadened since then. James Buchanan and the public choice school, for example, have added the regulator's own preferences and instincts for self-preservation back into the regulatory objective function. Others, notably Edward Kane, have emphasized the essentially competitive nature of what he would call the "regulatory service industry" especially in this age of the global market-place, to invoke the current cliché.

1.1 Regulatory slack and inertia: Some examples

Still others have stressed the important role in practice of what has been dubbed “regulatory slack” and regulatory inertia. Human beings grow old and die and pass from the scene. But not regulations and regulatory agencies. They have to be *killed* when the conditions that gave rise to them have changed. And that’s not easy. The classic example, of course, is the U.S. Rural Electrification Agency, instituted in the 1930’s when less than 10% of U.S. farms had electricity; and continued on into the 1990’s when less than 10 percent *don’t* have electricity.

Anomalies due to regulatory inertia have multiplied in recent years in the U.S. thanks to the master Budget Agreements negotiated between our Congress and our Executive branch. Under these agreements, it has become all but impossible to retire by legislation any regulatory rule that brings in money to the government even if *everyone* agrees that the social costs inflicted by the rule are many times the size of the revenue earned. To kill it, you have to replace with other taxes any revenue lost—or, more accurately, revenue *estimated* to be lost, taking all relevant elasticities as zero.

Regulatory inertia is an important extension indeed to Stigler’s 1971 version, and I don’t mean to downplay it. But for explaining the regulations we observe, the best strategy is still to begin, with Stigler, by assuming that someone in the regulated industry must be benefiting.

1.2 MOF, the SEC and the Brokerage Industry

For both MOF and the SEC I will refer to the industry receiving the benefits of regulation as the “brokerage industry,” construed broadly as the entire set of firms earning commission income from buying and selling (including underwriting) securities (mostly corporate securities) to outside investors.

I recognize, of course, that MOF’s jurisdiction extends well beyond the brokerage industry even as I have broadly defined it, but I want to focus here on the brokerage side to highlight the differences and similarities between MOF and the SEC. Our SEC’s jurisdiction is still limited largely to those dealing in corporate securities, even though the soon-to-be-former SEC Chairman, Richard Breeden, fought valiantly, though unsuccessfully, during much of his recent tenure to expand the SEC’s turf up to MOF-like dimensions at the expense of other regulatory agencies—notably against the Commodities Futures Trading Commission for jurisdiction over stock index futures; against the Treasury for the right to supervise dealers in Treasury securities, and against the Federal Reserve System for the right to set rules for reporting the values of securities held by banks.

I should add also that though the SEC’s nominal jurisdiction is smaller than MOF’s, the brokerage industry itself is much larger in the U.S. than in Japan. And I don’t just mean in terms of nominal dollar value. It was common to hear in recent years that the value of Japanese equities had actually surpassed that of the U.S., but even at the peak in 1989 that was never true when due allowance was made for the substantial amount of cross-holding among Japanese corporations and banks. And, of course, it’s even less true today after the Tokyo market has lost 50 to 60 percent of its peak value.

But regardless of how size is measured, the U.S. industry is clearly vastly more complex in terms of the variety of products and services it offers and of its constant innovation of new ones. In terms of complexity, the second largest industry is not really in Japan, but in Great Britain.

1.3 The alternative view of regulation

The Stiglerian view that both MOF and the SEC and their counterparts elsewhere operate primarily for the benefit of the brokerage industry is very different, of course, from the public positions advanced by those agencies themselves; and it is different as well, from how their roles are perceived by the general public.

The commonly-held “alternative view,” as Stigler dubs it, is that (and again I quote): “Regulation is instituted primarily for the protection and benefit of the public at large or some large subclass of the public” (p. 3). Thus our SEC would surely see its mission as protecting investors, particularly small and presumably less sophisticated investors against fraudulent and unfair practices by brokers, dealers and other industry professionals. And that vision conforms well with the public perception in the U.S. which sees the SEC not essentially as an agency dealing with “economics” as that term is usually understood, but as part of our criminal justice system—the scourge of the inside trader and the purveyor of worthless securities.

That the SEC sees itself and is seen as policing fraud in the industry actually confirms rather than contradicts Stigler’s industry-benefit theory of regulation. When the SEC was set up originally in the early 1930’s, the brokerage industry’s volume of business was in near total collapse—a collapse widely, if erroneously, attributed to fraudulent and illegal activities by Wall Street professionals.

The industry hoped that a tough-cop stance by the SEC would enhance the industry’s tarnished image and restore investor confidence, even if a few victims, like the Chairman of the NYSE, had to be ritually sacrificed in the process. That the memory of those desperate days still lingers is seen from a recent ad by the NYSE proudly billing itself as “the world’s most regulated stock exchange.”

Unlike the SEC in the U.S., however, MOF in Japan does not see itself, and is not seen by the public as an agency concerned mainly with rooting out fraud in the marketplace. In fact, many newspaper accounts I have seen, in translation, of course, have accused MOF of displaying too little zeal in stamping out fraud and corruption—a charge no one has ever leveled at our SEC.¹ In fact, our SEC has recently brought its regulatory thunder down on the heads of some of *MOF’s* constituents by bringing civil charges against Daiwa, Yama-ichi, Nikko and Nomura for a long list of securities-law violations in the U.S., including submitting false bids in the auction of U.S. Treasury securities.

Unlike the SEC, MOF is concerned less with law enforcement in the small than with managing the economy in the large. MOF sees its main task as maintaining high and rising levels of stock prices. High and rising prices not only benefit the investing public, MOF would argue, but make it easier and cheaper for Japanese firms to raise equity capital. And

¹ In response to public clamor, MOF has recently set up an SEC-style investigating unit, but unlike the U.S. SEC, it is not an independent agency. And until it actually brings a case and wins it, it will have to be considered just a paper tiger.

they create hidden reserves on the books of Japanese banks, making it easier for them to meet international capital requirement standards and thus to compete more effectively for loan business both at home and abroad.

So rosy, in fact, is MOF's view of its own regulatory role that one wonders why no other regulatory agency, and certainly not our own SEC, has ever sought to follow MOF's example and take stock price support as its main responsibility. Stigler's theory of economic regulation does indeed suggest why MOF alone has sailed on that tack, but that must wait until after documenting the specific ways in which MOF's regulation of the Japanese financial sector actually serves mainly the interests of the brokerage industry (and MOF itself).

2.0 *How Regulations Benefit the Brokerage Industry*

Stigler identifies 4 main channels by which the regulatory authorities can exert the power of the state to benefit particular industries: subsidies, price fixing, entry controls, and restrictions of substitute products. I want to focus mainly on the issue of substitute products, but first, a few words about each of the others, beginning with subsidies, the most obvious form of regulatory benefit.

2.1 Subsidies

Direct subsidies to the brokerage industry have not so far been a conspicuous feature in the U.S. But *indirect* subsidies do exist. A particularly controversial one at the moment concerns who pays for the salaries and other expenses of the regulators. The bills for our CFTC, for example, currently \$50 million per year, are picked up by the general body of taxpayers. But in Washington during the Bush years, some economists, many of whom had read the Stigler paper, wondered why the public should be paying for regulation when it was the industry that was benefiting. Accordingly, they proposed that a so-called user fee or transactions tax be imposed to defray the budget of the CFTC. The Clinton Administration, even more desperate to find budgetary savings, has recently revived the proposal.

The segment of the financial industry most directly affected by the proposed new charge have been resisting it desperately for several reasons. Nobody *likes* to pay taxes, after all. And the tax is economically inefficient. It's not a tax on the ultimate retail customers, but bears on market makers as well. But perhaps above all in feeding the industry's resentment is the belief that the benefits being obtained from CFTC regulation are not worth the price. The CFTC has much less credibility than the SEC as a market watch dog, and its attempts to increase its reputation capital have only driven up the industry's costs and further weakened its competitive position *vis a vis* foreign futures exchanges.

When it comes to MOF in Japan, however, direct subsidies to the industry are far more important than merely shifting MOF's salary burden to the taxpayers. MOF buys and warehouses stocks like our Agriculture Department buys and warehouses farm commodities. MOF has *de jure* control over investing the portfolio of the huge Japanese postal saving system and has *de facto* control over insurance company portfolios. And it has not

hesitated to use both portfolios in its price-support activities.

2.2 Entry controls

Getting direct subsidies can be a neat way of adapting the coercive powers of the state to the benefit of your industry, if, of course, you have the political muscle of swing it, and if you don't have to pay too big a price for it in other dimensions.

The classical example of paying too high a price is the U.S. airline industry which, in its early years, was more than willing to accept heavy-handed micro regulation by our Civil Aeronautics Board in return for the government's huge airmail subsidies. (And I mean heavy-handed. The CAB virtually told you how much lettuce you could put in a salad in first class.) But when the growth of regular air travel eventually dwarfed the mail subsidies, the industry suddenly became converted to free markets and led the charge for airline deregulation.

Short of direct subsidies, however, Stigler observes, and again I quote him, that "the second major public resource commonly sought by an industry is control over entry by new rivals" (p. 5). Here, of course, MOF has been masterful in defense of the incumbents in its brokerage industry, far more so than our SEC which has no power to issue, and hence restrict, brokerage licenses. The best our SEC has been able to do is to slow down entry somewhat by imposing on brokerage firms, high capital requirements, which inevitably bear disproportionately on small and struggling new entrants.

Even MOF's protective walls, however, have buckled in spots, though its task initially was much easier than that facing the U.S. regulators. The main potential new entrants feared by the incumbent Japanese firms were foreign brokerage firms and investment banks like Merrill Lynch or Morgan Stanley. And, of course, keeping foreign competitors out of its market had become almost an art form in Japan. But eventually even MOF had to cave in to relentless pressure, mainly from the U.S. And the big Wall Street firms finally did enter with consequences about what you would expect from major new entrants though, as I'll explain, in somewhat unexpected ways, at least unexpected by MOF.

I do not mean to suggest that MOF is in any way unique in its attempts to protect its domestic clients by blocking the entry of foreigners. The U.S. financial regulators do much the same thing whenever they think they can get away with it. It surely wasn't easy or automatic for Japanese firms to qualify as primary dealers in U.S. Treasury securities, even when Japanese citizens were major buyers of those bonds. And similarly for Japanese investors seeking to acquire a major stake in a U.S. futures trading firm. In fact, one of the few examples I know where the local regulators did not try to block out a foreign entrant was in London, where the Swedish option market firm OM tried to enter and did so easily and quickly first for options on Swedish stocks and then more generally. But then, option markets were never a big thing in London or it might have been different.

2.3 Price controls

The third class of public policies sought by an industry is price fixing. Stigler notes: "Where there are no diseconomies of large scale for the individual firm price control is essential to achieve more than competitive rates of return" even when the industry has achieved

entry control (p. 6). And MOF certainly has carried out its side of the bargain. Profits and volume in the industry may be low at the moment, but the minimum fixed retail commissions set by MOF are still among the highest in the world as are their mandated minimum underwriting fees.

MOF's price-fixing policies are sometimes contrasted unfavorably with the supposedly free-market approach of the SEC. But that comparison is not entirely fair to MOF. Before 1975, the fixed commissions mandated by our SEC were even higher than those of MOF. Nor was it some sudden access of free-market zeal that led our SEC to abandon its price-fixing policies. Market evolution had simply made those policies untenable.

The SEC's mandated single fixed-commission rate of 70 cents a share on round lots of 100 shares discriminated enormously against the pension funds and other institutional investors trading in lots of 10,000 or 100,000 shares. These institutional investors knew that they were being exploited—that \$7,000 on 10,000 share trade was at least one and possibly two orders of magnitude above the marginal cost of processing that order. To better control their trading costs the big pension funds tried to enter the brokerage business themselves by buying existing firms or by buying seats on a regional stock exchange. All to no avail. The SEC was able to thwart them at every turn. About all that institutional investors could do was to extract kickbacks and other concessions from the brokerage firms to whom they directed their order flow.

The SEC tried to slow this under-the-table erosion of its rate structure by grudgingly permitting some modest quantity discounts. But they were too little and too late. Under pressure of the great bear market and volume dry-up after 1973, the fixed-rate structure was close to collapse. In the face of the inevitable, the SEC, with some not-too-gentle prodding by the Anti-Trust division of the Justice Department finally abandoned its price-fixing policies on May 1, 1975.²

MOF in Japan is clearly going through much the same evolution. Kickbacks, under-the-table payments and associated scandals have become far too notorious in Japan to require further comment here beyond wondering why each new scandal seems to come as a surprise. Government mandated price restrictions, after all, are always and everywhere an open invitation to corruption.

MOF in the 1980's and 1990's has had, in some ways, an even more difficult task than our SEC in the 1970's in defending its fixed-rate structure, thanks to certain important technological developments in the securities industry. And that brings me to the last of Stigler's 4 classes of public policies sought by an industry from its regulators, namely the encouragement of complementary products and especially the suppression of substitute products.

2.4 The suppression of substitutes

As a specific illustration, Stigler cites the case of the butter producers who were able for many years to suppress the production and sale of margarine altogether; and when the

² The futures exchanges were also able to maintain fixed commissions, but more by direct collusion than by force of law. They too were forced to abandon fixed commissions in 1975 under pressure from the Anti-Trust Division.

ban eventually had to be relaxed under the pressure of butter shortages during World War II, the butter producers were able to prevent the margarine producers from coloring their product yellow. It had to look as unappetizing as so much lard.

Stigler's reference specifically to margarine was also a Chicago in-joke whose point is probably lost on most younger economists whose memories don't go back that far. In the 1940's, Stigler's long-time friend and mentor, Theodore (Ted) Schultz, then just a promising young agricultural economist, came to prominence by criticizing the ban on margarine and thereby getting himself fired from Iowa State University. Iowa's loss was Chicago's gain, needless to say.

Compelling as the margarine-suppression example was for Stigler, an almost limitless supply of such examples can be found in financial regulation, especially with respect to what have come to be called derivative securities—options, futures and swaps. These derivative products, after all, are designed precisely to be cheaper substitutes not for *owning* the underlying securities, but for *trading* them. And trading, with its commissions and related fees, is precisely what the traditional brokerage industry lives on. Calls for the regulators to suppress these cheaper substitutes are thus all but inevitable.

2.4.1 Options

Stigler couldn't have mentioned the equity derivatives in his 1971 article because they didn't then exist. Strictly speaking, equity options *did* exist, but only as a small and highly specialized sector of the Over-the-Counter market. Volume was minuscule, secondary trading was cumbersome, and commissions were high.

Exchange traded equity options *might* have existed as early as 1971, however, save for regulatory inertia of the SEC. The Chicago Board of Trade, confident that it could trade options on its floor far more cheaply than the OTC Put-and-Call Brokers in New York, had applied to the SEC for permission to list options as early as 1969.

The SEC reacted slowly, however, not so much to protect its main constituents in the stock brokerage industry—the Commission never really believed option trading would amount to much. And not to protect the regular Put-and-Call brokers—who were too small and too few to command much influence; but to protect the SEC itself. The Commission had to avoid being blamed for setting off a speculative explosion like that supposedly in the 1920's which in turn led to the Crash of 1929 and eventually to the SEC in 1933.

We can smile today at these and related concerns (such as that giving risk takers the opportunity to trade options might dry up the flow of equity capital to the corporate sector), but options were very poorly understood in those days. The Black-Scholes model, for example, was still two or 3 years away. And not everyone at the SEC realized the world of difference between a substantial reduction in option *premiums* and a substantial reduction in option *trading costs*, which was, of course, all that the CBOT was actually promising.

But the SEC had more than just these macro concerns. A major worry was that opening a second market in options might outflank some of the key regulations in its main market, the NYSE, notably the insider trading restrictions and the so-called "uptick rule." The uptick rule is a uniquely American way of regulating short sales. In some other countries short sales are either banned altogether by the regulators (as they were in Sweden before the recent capital market liberalization). Or they may be regarded as unenforceable in law (which ruling, and not the Tulip bubble, is what really killed the Amsterdam Stock

Exchange in the 17th Century). Many among the general public of stock owners undoubtedly *wish* the SEC would ban short sales. But there are too many legitimate technical reasons for short sales, particularly on the part of dealers and market makers, to prohibit them completely. So the SEC compromised. You *can* sell short, but you must actually borrow the shares physically; put the proceeds from the sale of the borrowed shares into escrow; and make the sale of those borrowed shares at a price no lower than that of the previous transaction.

That last restriction is the uptick rule. And it's a very popular restriction indeed. Even though there is no evidence it's effective, many in the brokerage industry and among its customers, see it as a fundamental protection against "bear raids," cascading waves of short sales hammering prices ever lower. And those views are shared by other SEC constituencies such as underwriters of new stock issues, and the owners of corporations who would *like* to bring out primary or secondary offerings of their shares if only those awful speculators would just stop undermining the underwriter's efforts to keep the offering price high.

The SEC soon realized that it couldn't just extend the uptick rule to options, if only because CBOT-style, open outcry markets don't have sequential ticker tapes. That's strictly a stock exchange feature. So to keep the bears from exerting their downward pressure on prices via the option market, the SEC agreed to approve trading initially only in calls, not puts—surely one of the silliest rulings ever made by a regulatory agency. By the time the SEC learned about the Put-Call Parity Theorem a years later, the CBOT's substitute market, now known as the Chicago Board Options Exchange (CBOE) was too firmly entrenched to be dislodged.

2.4.2 The regulatory battle over index futures in the U.S.

Ten years after options first appeared on the scene, another low-cost derivative stock-substitute product suddenly appeared to compete vigorously with the traditional brokerage industry. The options approved for trading in 1972 had all been single company options. The new development was stock-index futures, especially the CME's S&P 500 Index contract—a product with great appeal to the pension funds and other institutional investors who not only held (and traded) large diversified portfolios but who regularly used the S&P 500 Index as a benchmark for measuring performance.

So appealing was the new index futures product and so rapid was the growth of institutional investors that within 3 years the per share equivalent of futures trading exceeded that of the NYSE itself. Some part of this huge futures volume was surely net new business because it really *is* cheaper to rebalance big portfolios between equities and cash with a single futures transaction rather than hundreds of separate stock transactions. There's also more price impact to the separate trades in individual stocks because the market is less sure that the trades are not being driven by special information advantages. Some of the futures volume, of course, fed back to the NYSE via index arbitrage, but that hardly mollified the old-line retail firms who believed that those computer-driven arbitrage programs were using up too much of the market's normal liquidity and were frightening away too many of their small, but still lucrative retail customers.

The SEC had to listen with some embarrassment to these complaints from its constituents because, in a way, it really *had* let them down. When index futures were first being

proposed in the early 1980's, the CME actually had approached the SEC as the presumed regulator of equity products, much as the CBOT had approached the SEC 10 years earlier for permission to trade options. The SEC, however, spurned the offer, misled perhaps by the very modest volumes of trading for individual stock options up to that point.

But basing the contract on an index made all the difference in the world not just for the CME, but also for the CBOE which introduced that same year its own S&P 100 option contract—a contract whose volume of business quickly surpassed that of all the individual options combined even though the SEC initially set position limits so low as to make the product unattractive to large institutional investors. By the time the SEC realized its mistake in signing off on the CME's S&P 500 futures contract, it was too late to get the jurisdiction back. The contract was now regulated by the CFTC, a smaller and less prestigious agency, surely, but like any other agency, not willing, voluntarily, to relinquish any turf. The best the SEC could get out of its prolonged negotiations with the CFTC was the so-called Shad-Johnson accord of 1984 under which the CFTC agreed not to authorize any index so narrowly based or so heavily weighted by a single stock as to be an effective substitute for a single stock (e.g., for purposes of insider trading).

The SEC, its brokerage industry constituents and its Congressional overseers (notably Congressman John Dingell of Michigan) continued to complain about the competition from index futures with absolutely no success until the fateful day of October 19, 1987—the day of the Great Crash. They all thereupon immediately blamed the CFTC-regulated futures industry for the Crash and demanded that jurisdiction over index futures be transferred back to the SEC. Their “one-market, one-regulator” cry was soon taken up by the Presidential Commission on Market Mechanisms chaired by Nicholas Brady. Brady himself was a leading member of the old-line investment banking community, and his other commissioners were drawn entirely from the ranks of Wall Street and corporate establishments. No one who actually knew anything about index futures or options was asked to serve and no economists, not even George Stigler who had volunteered to serve.

The Brady Commission Report would have had its justly-earned 15 minutes of fame and then been forgotten save for one special circumstance. Nicholas Brady soon thereafter became Secretary of the Treasury and a most influential person indeed in the councils of the Bush Administration.

I shall not review here in any detail the subsequent history of the bitter jurisdictional dispute between the SEC and the CFTC—which some have dubbed the Brady-Breedon attempted hostile takeover of the CFTC—beyond noting that the proposed regulatory takeover was a failure. The futures industry and the CFTC were able to fend off their seemingly much more powerful political and economic rivals for reasons long stressed by the public choice theorists. The cost of our sugar import quotas, for example, when spread over the whole consuming public amounts to only a few dollars each per year. But for the smaller number of sugar producers, the gains are a tidy sum, providing both the motivation and wherewithal to fight and win the political battles to retain the quotas. And similarly for the CFTC and its futures industry constituents. The retail stock brokerage industry is larger than the futures industry but it is also more diffuse.

The futures industry was not only more heavily concentrated regionally but, thanks to the historical origin of futures trading in hedging corn, wheat and other farm commodities, supervision over the futures industry was lodged with the agriculture committees in

Congress, even though the trading by 1987 was mostly in interest rate, stock and foreign currency futures. I needn't remind anyone here in Japan of just how politically potent the agricultural bloc can be. There was never any real prospect that the powerful agriculture barons in the U.S. Congress would not resist the takeover threat to their jurisdiction.

The agriculture bloc was not powerful enough actually to checkmate the securities bloc, but it could and did force a stalemate. And during the more than two years of delay and maneuvering after the Brady-Breeden attack was launched, the brokerage industry lost its enthusiasm for continuing the fight. More and more stock brokerage firms have added a futures trading capacity to their regular lines. The two segments of the industry have intermarried, as it were. Retail stock volume has recovered substantially from its 1988 lows. The NYSE has also taken a number of steps on its own that have managed to quiet the clamor over index arbitrage and program trading without actually affecting either. The NYSE has shifted its attention from the futures exchange to the far more serious competitive threat it faces from off-exchange trading of its listed stocks.

2.4.3 Postscript on recent futures industry proposals for a new regulatory structure

Let me add a brief postscript for the benefit of those who have read recent accounts of the futures industry's call—yes, the *futures* industry's call—for a single financial regulator!

What's *that* all about and how do we reconcile it with their past all-out resistance even to the mention of the idea. And how do we reconcile it with the Stigler model?

The answer is, basically, that the industry is trying to get better, that is, lower-cost regulatory service. The futures industry came to realize that by seeking the protection of the Agriculture bloc against the security industry, it had made a Faustian bargain. The Agriculture bloc *did* protect them, but exacted a heavy price by imposing its own, farmer-oriented agenda on an industry that was now part of the financial sector.

The futures exchanges would dearly like to get out from under their agriculture overseers, but don't want to turn to the SEC. The SEC commissioners can't be trusted because their hearts lie elsewhere. So the futures industry has recommended that a new, cabinet-level Department of Financial Regulation be set up, organized along functional lines into 8 separate (but equal) operating divisions: Prudential and Systemic Risk (mainly, capital requirements); Fiduciaries and Pooled Vehicles (mutual funds); Disclosure and Reporting; Investment Securities Markets (debt and equity instruments, mainly); Risk-Shifting Markets (futures and options); Banking and Insurance; Customer Insurance (FDIC, SIPC, and PBGC); and Consumer Protection.

That an organization so structured would indeed reduce much of the wasteful duplication in current arrangements is clear enough. But that a unified structure along MOF-like lines offers a safe haven for the futures industry is certainly *not* clear.

2.4.4 Index futures in Japan

For while the U.S. brokerage industry and its regulator have adapted, albeit grudgingly, to the competition from futures and options, the fight to suppress these substitutes continues unabated in Japan, and is even spilling over the borders of the country itself.¹

The difference in evolution reflects undoubtedly MOF's previously noted self-view

¹ For a fuller account of MOF's war against index futures see Miller (1983).

of its main function as that of propping up the level of stock prices. Left to its own devices, MOF would probably never have permitted index futures trading. MOF authorized futures trading only reluctantly and only after intense pressure from the U.S. in support of its financial service industry firms who saw trading in derivatives as the one area in which they had the expertise to compete effectively for business in Japan.

MOF saw index futures as a threat to its policies for discouraging selling—not just short-selling but *any* selling. Short-selling was already hard to do thanks not only to MOF rules but to the practice of many Japanese companies of encouraging stockholders to show their loyalty by registering their shares at frequent intervals. That way, the companies would know who was lending shares to the shorts. The practice of extensive cross-holdings of shares between Japanese firms also reinforces incentives against selling by creating what amounts to a mutual exchange of hostages.

Futures trading could undermine these taboos against selling because futures were effectively impersonal instruments. Equity exposure could be reduced at any time merely by taking a short position in futures. The underlying shares need never even leave the vault. They could be presented for reregistration whenever called upon. Yet, for all practical purposes, they had effectively been converted to cash.

MOF's nightmare was that the Japanese insurance companies, taking advantage of the anonymity of futures trading, would hedge their portfolios and unleash a torrent of selling, like that associated with portfolio insurance in the U.S. But MOF needn't have worried. Their accounting and tax regulations had already made hedging uneconomic for insurance companies. And, despite the steady erosion in equity values after 1989, Japanese insurance companies were actually *buying* futures not selling futures.

They were actually *increasing* their equity exposure despite the fall, because they believed that MOF would soon intervene and push the prices back up. If you really believe MOF will support the price—and many did and many disillusioned ones are coming to believe it again—then you're not buying stock, you're buying a call option.

If the Japanese insurance companies were *buying* futures, who was selling them? The answer, of course, was the foreign investment banks, especially those that had been allowed to buy seats on the Tokyo Stock Exchange. These firms were making literally hundreds of millions of dollars a year, despite the steady fall of Japanese stock prices, merely by a simple and straightforward arbitrage. The arbitrage, however, was not the same as that between the New York and Chicago markets. In Japan, what was being arbitrated was not small price differences but large *commission* differences.

Thanks to MOF's fixed commission policies, the cost to a customer for establishing or adjusting diversified portfolios of equities in Japan was not just 3 or 4 times higher with stock than with futures, as in the U.S., but anywhere from 30 to 40 or more times higher. Higher to outside customers, that is. But not, of course, to any foreign arbitrage firms with seats on the Tokyo Stock Exchange. They could buy stocks directly on the Exchange and then hedge by selling futures to ordinary Japanese investors. The futures contracts, though quoted at a substantial premium to theoretical cash value—Japanese futures were said in the trade to be “rich”—were still a bargain for Japanese investors relative to buying stocks at full retail commissions.

That MOF did not at first understand this process of arbitraging commissions is clear from MOF's frantic attempts to dissuade the foreign arbitrage firms from unwinding their

arbitrage positions. MOF knew enough to realize that unwinding the positions meant selling the stocks. But not enough, apparently, to realize that it also meant buying futures, which would exert an equal and opposite effect on the price level. The foreign firms, of course, were more than eager to accommodate MOF. Every time they rolled over their positions at MOF's behest, they made more money!

That MOF has finally figured it, however, is clear from a number of MOF's more recent actions which have greatly increased the cost of trading index futures for everyone, domestic users and foreign arbitrageurs alike. Commissions on futures have been raised as have margin requirements. Hours of trading on the Osaka Stock Exchange have been cut and elaborate price limits and circuit breakers have been installed that future restrict the effective time for trading futures in Osaka. But all that did was move huge chunks of the business offshore to Singapore.

MOF's attempts to staunch that flow to Singapore by browbeating Simex to bring its fees and margins back into line with Osaka have been an embarrassing failure. The Simex people simply laughed at the visiting delegation from MOF and the Tokyo Stock Exchange. Nor have MOF and the TSE been any more successful in their efforts to get IOSCO (the International Organization of Securities Commissions) to support their position against Simex or to enunciate a policy of giving each country exclusive rights to regulate futures on indexes whenever traded.

The Simex case is not the first time, of course, that MOF's policies have driven Japanese markets overseas. MOF restrictions, plus MOF-mandated high fixed underwriting fees "hollowed out" the Japanese bond and warrant market creating a Eurobond market in which both Japanese firms and Japanese investors trade in London.

3.0 *Conclusion*

The natural inclination of most academic economists confronting so much evidence of the damage MOF has inflicted on the Japanese capital markets is to recommend a thoroughgoing deregulation. Tear MOF down and start over. Why should a 20th Century economy be saddled with a 17th Century regulatory structure?

And, in that spirit I and many others have suggested recently that a useful first step to establish some credibility for a major deregulation would be to end the fixed brokerage commissions like we in the U.S. did in 1975. That would also help solve two other problems vexing MOF: it would reduce the pressure for kickbacks and also reduce index arbitrage.

Stigler would deride proposals like mine as hopelessly naive. He writes:

The idealistic view of public regulation is deeply imbedded in professional economic thought. So many economists, for example, have denounced the ICC for its pro-railroad policies that this has become a cliché of the literature. . . . The fundamental vice of such criticism is that it misdirects attention. . . . The only way to get a different commission would be to change the political support for the Commission and reward commissioners on a basis unrelated to their services to the carriers. (p. 18)

Read hastily that passage too may misdirect attention to the overly narrow matter

of the pecuniary rewards flowing to the regulators from the industries they regulate. That's important surely, particularly in Japan, where every MOF bureaucrat's dream is to "descend from heaven" at retirement into a highly paid sinecure in one of the big brokerage houses. Nor is it very much different in the U.S., I hasten to add. The current Chief Executive Officer of NASD, for example, is the former chief of the SEC's Market Regulation Division. And that street runs both ways. The current Chairman of the SEC is the former Chairman of the American Stock Exchange.

But there are also real differences between the SEC and MOF. The SEC did, after all, however reluctantly, abandon fixed commissions. And, except to the limited extent of its uptick rule, the SEC has never held itself out as supporting the level of stock prices.

Our SEC has carefully avoided taking on any such responsibilities, even by implication, and for two reasons. First, unlike MOF, the SEC knows that the policy won't work. It may *seem* to work for short periods if great sums of money are pumped in; but stock prices can't be kept indefinitely from reflecting their true economic fundamentals. If those fundamentals are bad, then, sooner or later, the level of stock prices will be adjusted downward, possibly abruptly.

And that's the second and decisive reason for the SEC's unwillingness to accept responsibility for prices: When the inevitable adjustment comes, they will take the blame for the failure of the price support policy. They and their political sponsors will be swept out of office. And now we're getting to the heart of the matter. MOF and its sponsors don't have to pay the costs of failure of its policies, even adject failure, because there is no effective political competition in Japan.

Stigler, referring to the political environment in the U.S., notes that, and again I quote him:

If one party becomes extortionate (or badly mistaken in its reading of effective desires), it is possible to elect another party which will provide the governmental services at a price more closely proportioned to the costs of the party. (p. 13)

Until that kind of political competition comes to Japan, I am sorry, as an academic, to have to conclude that all talk of financial deregulation and reform in Japan is likely to be just that—academic.

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