

**Symposium on Building the Financial System of the 21st Century:
An Agenda for Japan and the United States
Warrenton, Virginia • September 20-22, 2002**

Friday, September 20, 2002

6:15–6:50 Cocktail Reception in Airlie Room

6:50 Dinner in Airlie Room

Greetings

Hiroshi Ota, Counselor, The Japan Forum on International Relations, Inc.

Hal Scott, Nomura Professor & Director, Program on International Financial Systems,
Harvard Law School

Robin Radin, Associate Director, Program on International Financial Systems, Harvard
Law School

Keynote Addresses

Kenneth Dam, Deputy Secretary, United States Treasury

Hakuo Yanagisawa, Minister for Financial Services

Saturday, September 21, 2002

7:00-8:30 Breakfast in Airlie Room

7:00-8:30 Breakfast Meeting of Facilitators and Reporters in Garden Room

8:30-8:40 **Welcome & Opening Remarks in Federal Room**

Hiroshi Ota, Counselor, The Japan Forum on International Relations, Inc.

Hal Scott, Director, Program on International Financial Systems, Harvard Law School

8:40-9:00 **Session 1: Accounting Reforms and Auditor Independence in Federal Room**

Japanese Panelist: Yasuhisa Shiozaki, Member of the House of Representatives

U.S. Panelist: Michael D. Mann, Richard Spears Kibbe & Orbe

U.S. Panelist: Georges Ugeux, Group Executive Vice President, International,
New York Stock Exchange

9:00-10:25 Small Group Sessions

<i>Group</i>	<i>Room</i>	<i>Facilitators</i>	<i>Reporter</i>
1	Jefferson Room	Hiroyuki Kamano & Jonathan Colby	Hal Scott
2	Audobon	Hideki Kanda & Richard Medley	Robin Radin
3	East Room	Akira Ariyoshi & Wilbur Ross	William Grimes
4	Garden Room	Akihiro Wani & Jeffrey Young	Hugh Patrick
5	Meadow Room	Shuji Yanase & David Asher	Jacob Weinstein

10:25-10:40 Refreshment Break

10:40-11:10 **Session 2: Information Flow to Capital Markets in Federal Room**
 U.S. Panelist: Douglas Shulman, President, Regulatory Services & Operations, NASD
 Japanese Panelist: Mineko Sasaki-Smith, Chief Strategist, PricewaterhouseCoopers Consulting
 Japanese Panelist: Mitsuhiro Fukao, Professor, Faculty of Business & Commerce, Keio University

11:10-12:30 Small Group Sessions

Group	Room	Facilitators	Reporter
1	Meadow Room	Mineko Sasaki-Smith & Robert Fallon	Hal Scott
2	Jefferson Room	Takayoshi Hatayama & Clifford Shaw	Robin Radin
3	Audobon	Hiroshi Ota & David Hale	William Grimes
4	East Room	Akinari Horii & William Seidman	Hugh Patrick
5	Garden Room	Yukinori Ito & Mark Norbom	Jacob Weinstein

12:30-1:30 Lunch in Airlie Room
Keynote Address
 R. Glenn Hubbard, Chairman, Council of Economic Advisers

1:30-2:30 **Session 3: Regulatory Reform in Japan in Federal Room**
 Japanese Panelist: Yasuo Kanzaki, Special Advisor, Nikko Salomon Smith Barney
 Japanese Panelist: Reese Harasawa, Director, Credit & Investment Policy, The Bank of Tokyo-Mitsubishi
 U.S. Panelist: Robert Dugger, Managing Director, Tudor Investment Corporation
 U.S. Panelist: Arthur M. Mitchell III, Partner, Coudert Brothers

2:30-6:15 Free time

2:30-5:00 Reporters (from Small Group Sessions) meeting in Jefferson Room

6:15-7:00 Cocktail Reception in Airlie Room

7:00 Dinner in Airlie Room
Keynote Address
 Roger W. Ferguson, Jr., Vice Chairman, Board of Governors of the Federal Reserve System
 Haruhiko Kuroda, Vice Minister of Finance for International Affairs, Ministry of Finance

Sunday, September 22, 2002

7:00-8:00 Breakfast in Airlie Room

7:00-8:00 Breakfast Meeting of Discussion Chairmen and Steering Committee in Garden Room

8:00-9:45 **Presentation & Discussion in Federal Room**
Japanese Regulatory Reform
 Japanese Chairman: Takatoshi Ito, Professor, The University of Tokyo
 U.S. Chairman: Thierry Porté, President, Morgan Stanley Japan Limited
 Reporter: Hugh T. Patrick, Director, Center on Japanese Economy & Business, Columbia Business School

9:45-10:00 Refreshment Break

10:00-11:45 **Presentation & Discussion in Federal Room**

Accounting Reforms, Auditor Independence and Information Flow

Japanese Chairman: Yasuhiro Maehara, General Manager in the Americas, Bank of Japan

U.S. Chairman: Richard A. Fuchs, Partner, Global Capital Markets Group, Asia Pacific Theatre Leader, PricewaterhouseCoopers LLP

Reporter: Hal Scott

11:45-1:30 Closing Lunch in Airlie Room

SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEM
OF THE 21ST CENTURY:
AN AGENDA FOR
JAPAN & THE UNITED STATES

September 20-22, 2002
Warrenton, Virginia

The fifth Symposium was held at Airlie Center in Warrenton, Virginia, following a tumultuous summer for both the U.S. and Japanese financial systems. The Japanese financial system remained mired in economic stagnation, goods and asset price deflation, increasing non-performing loans (NPLs), and high bankruptcies. The U.S. financial system, meanwhile, was experiencing economic slowdown, falling equity prices, and the fallout from a series of high-profile accounting scandals that reduced global confidence in the quality of U.S. financial disclosure and corporate governance. On the policy side as well, both financial systems had seen well-publicized initiatives, including the passage of Sarbanes-Oxley in the United States and a Bank of Japan proposal to purchase excess equities from Japanese banks. The specific problems in both economies were potentially exacerbated by slower growth – and possible prospects of deflation – worldwide.

Japanese Banking Reform and Corporate Restructuring

As in previous Symposia, questions of Japanese banking reform and corporate restructuring dominated much of the discussion. Participants raised a number of questions about the current situation, and many expressed doubts about the quality of policies that have been put in place to deal with problems in these areas.

The Financial Services Agency (FSA) was a major focus of discussion. Foreign financial market participants in particular voiced suspicion about the accuracy of information being supplied about the Japanese financial system. As in previous years, estimates of NPLs and bank capital provoked considerable skepticism, with some participants charging that FSA was responsible not only for distorting its own data and analyses but also pressuring financial analysts to produce more optimistic reports than they might otherwise produce. These issues were seen to feed into a larger problem of transparency and information disclosure in the Japanese economy. Meanwhile, issues of how to handle the deposit insurance “payoff” limits and the distortionary effects of postal savings continued to be causes of concern.

In contrast, other participants either defended the performance of the FSA or argued that the accuracy of the numbers and the mechanics of specific FSA programs to deal

with NPLs and bank equity holdings were far less important than renewed economic growth and an end to deflation. In this view, anti-deflationary monetary and fiscal policies were prior conditions to fixing structural problems of the banks.

Two recent events were cited in many discussions as potentially very important to Japan's options in terms of both financial and fiscal policies – the September 18 announcement by the Bank of Japan that it would purchase significant amounts of banks' excess equity holdings, and the September 20 shortfall of bids for new 10-year Japanese government bonds (JGBs). While there was almost unanimous skepticism that the BOJ move would be an effective solution to the problems of bank capitalization, a number of participants expressed understanding of the frustration that the BOJ apparently felt with the tentative actions of the government in that regard. Some also felt that the BOJ announcement might force the government to act more boldly. Meanwhile, there were divided opinions regarding the meaning of the JGB auction shortfall. While some saw it as a temporary and insignificant glitch in the otherwise smooth financing of government debt, others suggested that it demonstrated increasing market concerns with the viability of Japanese government debt and with the effectiveness of NPL disposal and bank capitalization issues.

Capital Adequacy

The issue of capital adequacy for banks was a much-discussed topic, as in previous years. At the Airlie Symposium, several factors contributed to renewed worries. One of these was the continuing slide of Japanese stock prices. Since Japanese banks have not rapidly reduced their holdings of stocks, their capital positions have continued to drop along with stock prices. A number of participants pointed out that the need to mark assets to market for mid-year and end-of-fiscal-year accounting requirements meant that many banks would find themselves in a position of capital insufficiency at the end of the month of September.

While the FSA has continued to certify the capital adequacy of major Japanese banks, a number of participants voiced skepticism about the quality of such statements. One issue raised was that a considerable part of Japanese banks' capital is made up of "deferred tax assets" – in other words, future tax deductions based on write-downs of non-performing loans. However, the current (and presumed future) lack of profitability of virtually all banks means that such tax deductions are not actually worth anything. Only if profits reappear will deferred tax assets have value. To make matters worse, a

number of participants pointed out that under current rules, deferred tax assets expire in a relatively short time, so profitability would have to return quite soon in order to take advantage of them.

An additional problem has been the continuing increase in the magnitude of the NPL problem. Using official NPL estimates, it was pointed out that NPLs have increased more rapidly than write-downs, thus constituting a continuing drain on bank capital. Those who distrusted the official estimates suggested the situation was even worse. Unless the pace of new NPLs slows, participants feared that even aggressive write-downs or bank recapitalization would be ineffective in resolving the problems of Japanese banks. For many, therefore, the key to solidifying banks' capital positions will be to stem the NPL problem.

Two main explanations were offered regarding the source of the increasing NPLs. One was the need for corporate restructuring (see below). The other was that continuing deflation and low nominal interest rates have created an impossible situation for banks. A key argument was that deflation and stagnant economic growth have made it difficult for companies throughout Japan – no matter how well-managed – to make money, and thus to pay back loans to banks. Low interest rates have also made it difficult to price in a reasonable risk premium – a problem made worse, according to some participants, by FSA directives to continue lending to struggling small and medium-sized enterprises (SMEs). (There was some sympathy for the FSA position on SME lending, since several participants argued that the FSA must answer to the preferences of members of the ruling coalition who are concerned about the fate of SME constituents. Also, there remained fears concerning the macroeconomic effects of mass bankruptcies of SMEs.)

Meanwhile, low nominal interest rates have made it difficult for banks to make money on their core business. Numerical examples were presented that showed that the spread between deposit and lending rates is too narrow to cover administrative costs and the risks of non-payment. Only an end to deflation would be likely to offer a solution to the problem of negative effective spreads. The policy implication of this analysis was anti-deflationary monetary and/or fiscal policies. Contradicting this analysis, however, other participants argued that reflationary policies would be ineffective until banks cleaned up their loan portfolios and forced major restructuring by troubled borrowers.

While virtually all participants agreed on the need for recapitalization of banks, different analyses of the core of the problem led to several different recommendations

for action. Those who identified the main problem as deflationary environment were most sympathetic to the need for rapid recapitalization funded by the government or the BOJ. With stable new capital in hand, they argued, banks would be financially able to deal with the NPL problem and regain profitability. Their ability to make new loans would also contribute to the problems of deflation. Other participants were skeptical of publicly-funded bank recapitalization, on the grounds that bank mismanagement was responsible for much of the banks' plight. They argued that bank recapitalization should have strong conditions; some felt that the only way performance conditions could be imposed would be force some banks into bankruptcy. (Some pointed out that current law also makes it difficult to impose recapitalization on non-failed banks, and thus nearly impossible to impose strict conditions on them.) Another problem seen by many participants was that better managed banks should be rewarded relative to poorly managed ones, but that previous recapitalization schemes had not made such distinctions.

Macroeconomic Issues

As in previous Symposia, macroeconomic issues loomed large in Airlie – with the significant twist that there was increasing concern about the U.S. economy as well as Japan's. The most prevalent concern voiced was of continued deflation in Japan. This was seen as a very serious problem for all aspects of the Japanese economy, but particularly for banks. Concerned participants pointed out that banks were subject to at three adverse effects of deflation: asset deflation reduced the value of their capital, low corporate profitability increased their NPL problems, and extremely low nominal interest rates made it impossible for banks to make money on their lending margins.

To address this problem, there was widespread agreement that much more aggressive quantitative easing by the BOJ would be necessary, and many expressed frustration with the BOJ's perceived reluctance to take the appropriate measures. On fiscal policy, opinion was more divided. While many participants agreed that the fragile Japanese economy needed continued fiscal support in the medium term, others argued that the size of Japan's public debt made such action irresponsible and perhaps even unsustainable. Most participants were leery of continued pump-priming through inefficient public works projects, and instead urged broad-based tax cuts as the most effective measure in both providing short-term stimulus and preventing long-term inefficiencies.

The sustainability of Japan's public debt was avidly discussed. There was a clear consensus that Japan's debt is unusually large and that some sort of debt consolidation plan would have to be considered. However, there was no consensus as to urgency. Some feared that investors would eventually become unwilling to fund the massive debt, and that a sudden outflow of funds from JGBs and from Japan itself could create a severe hard landing for the economy, while others foresaw a more incremental progress of economic malaise. The latter based their relative lack of pessimism on the continued high level of private savings and the potential for future tax hikes after the economy had begun to recover. The key, they argued, would be to bring about a sustainable recovery before cutting back on the fiscal side.

Meanwhile, for the first time in several years, the sustainability of U.S. debt was a topic of serious concern among some participants. The existence of twin deficits means that the U.S. government and financial markets must depend on capital inflows to remain sustainable. While the U.S. economy had been seen as a safe harbor in the world economy for a number of years, some argued that the current asset deflation might foretell a shift toward net outflows. Others disputed that analysis, pointing out that foreign markets were also performing poorly, and arguing that reforms such as Sarbanes-Oxley would keep U.S. markets attractive to investors around the world.

Another concern regarding the U.S. economy was whether asset price deflation would have a deeper effect on the economy. Some pointed out that the decline in the value of U.S. equities was at a level that had not been seen since the Great Depression, and worried that it was inevitable that consumer spending would sooner or later respond to that loss in wealth. Other participants were less concerned, pointing out that paper wealth increases had not been fully reflected in spending increases during the U.S. stock market bubble and so that it was unlikely that decreases in consumer spending would be proportionate to paper losses. Also, the housing market remains robust in most of the United States, so most consumers have not actually seen major losses in wealth.

While participants acknowledged that the U.S. situation was a difficult one, there was a consensus that Japan's macroeconomic problems remained considerably worse. A common explanation for the persistence of stagnation in Japan was a political one. Participants saw disappointingly little appetite for serious changes that could create a basis for long-term recovery but that would hurt many vested interests. The main point of dispute was whether (a) the Japanese people prefer the policies they have been getting or (b) the political structure has prevented more forward-thinking politicians and

officials from carrying out necessary reforms. As one participant said in frustration, “NPLs are a tax on Japan’s future,” but the Japanese political system continued not to be willing to face the trade-off.

Deposit Insurance

Another important issue for the banking system was that of deposit insurance. The issue is related to bank capitalization and NPLs insofar as the weak condition of many Japanese banks has raised the likelihood of bank failures. With the current deposit insurance limit of ¥1 million per depositor set to expire at the end of the fiscal year, there were once again fears that large depositors would leave smaller banks in droves for the relative safety of large banks (often seen as “too big to fail”) or postal savings. Fearful of the financial disruption this would cause, in September the FSA proposed an exemption from deposit insurance limits for so-called “settlement accounts,” a new type of account that would pay no interest and the rules for which remained undefined. Most participants thought this situation might be difficult unless “settlement accounts” were just another name for demand deposit accounts. (Editor’s note: Financial Services Minister Takenaka announced in early October that the deposit insurance limit would be extended for all demand accounts.)

There was additional debate over whether extension of unlimited insurance would contribute to the long-term health of the Japanese banking system. This discussion continued an active debate from the Gotemba Symposium in December 2001, in which advocates for imposing strict limits on demand deposits argued that such limits would be important in separating well-managed banks from poorly-managed banks (with the latter going under). Interestingly, in discussions at the Airlie Symposium, there was considerably greater sympathy for extending the unlimited payoff than at Gotemba. The main reason given by participants for favoring extension was fear of financial system chaos.

The question was also raised of who should have to pay to cover deposit insurance, and how. This was raised as an issue of both practicality and of fairness. From a practical point of view, widespread bankruptcies would require far more resources than the Deposit Insurance Corporation (DIC) currently has. Thus, the burden for dealing with the issue will fall either to banks (in the form of increased premiums) or to taxpayers. Given the already-existing problem of negative spreads, increasing premiums would only further erode banks’ profitability. At the same time, use of

taxpayer funds was seen as politically untenable. It was also pointed out that the problem would only be exacerbated by protecting large accounts (whether in the form of settlement accounts or ordinary demand deposits), since this would significantly increase the likely payoff amounts. Moreover, the question of fairness was raised, since it would force small depositors or taxpayers essentially to subsidize risks taken by large accountholders.

Problems of Financial Regulation (FSA Problems)

In many of the discussions of banking issues, the regulatory role of the Financial Services Agency was a major topic. A number of participants were sharply critical of the FSA's oversight, and of then-Financial Services Minister Yanagisawa's refusal to consider public funding for recapitalization and purchase of problem loans by the Resolution and Collection Corporation.

A key complaint was that the FSA has not adequately enforced accurate assessments of NPLs. The argument was that the FSA is unwilling to see large numbers of banks fail, and therefore has soft-pedaled rapid recognition and disposal of bad loans. Some felt that the reason is the Japanese tradition of informal regulation, which has led to inspectors seeing themselves as "coaches" rather than "enforcers." Meanwhile, the unwillingness to see banks fail seemed to many to be a continuation of the convoy system, and they expressed concern that the lack of differentiation between good and bad banks only added to the general problem of bank misbehavior. Following up on the accusation that the FSA was too concerned with the survival of even bad banks, several participants suggested that the FSA had actually pressured analysts to maintain positive evaluations of firms and banks in order to prevent downward pressure on banks' capital bases. An even more serious accusation was that the FSA pressured banks to continue lending to non-viable firms ("zombie corporations") to keep them afloat. This problem was seen as especially endemic in lending to SMEs.

In this regard, there was sympathy for Minister Yanagisawa's desire to introduce market discipline and eliminate forbearance as a central principle of financial regulation. However, many participants were highly critical of the reluctance of Minister Yanagisawa and FSA officials to commit public funds to deal with the capitalization and NPL problems. Without an infusion of public capital, went one argument, banks would be unwilling to fully recognize their NPLs, since to do so would be to push their own capital below the legal limits. The opposite causality was also argued. Until the RCC started

disposing of loans it had warehoused, market prices would never be established and there would never be a wholesale disposal of NPLs. While prices would initially be low, the argument went, they would go up as auctions became a common event. But without public funding for NPL disposal, a market would not be established and banks' capital positions could not be expected to improve.

Those who were critical of financial regulatory policy looked to political expediency as the main culprit. (In partial contrast, with regard to implementation, some focused more on the personal incentives facing individual FSA inspectors to have a cooperative relationship with banks they regulate.) Anti-reform politicians, particularly within the LDP, were understood to oppose bankruptcies of banks and borrowers that were constituents or offered other support, and created great pressure on financial regulators not to push too hard. Such forces also stymied attempts to change the laws in order to strengthen financial regulation. Finally, it was argued that strong public sentiment against "bailing out" banks with public funds for recapitalization or covering RCC losses made it difficult to get political leadership to advocate such policies.

While many participants voiced unhappiness with Japanese financial regulation, others defended the FSA. They felt that the FSA had significantly improved standards for judging NPLs and bank capital, and that the organization has been doing relatively well with the limited resources at its disposal. Important constraints included the limited numbers of bank examiners, the difficulties of ensuring sufficient training, and the large-scale changes in Japanese finance in recent years. The preferences of politicians also created serious constraints on the abilities of the organization.

Corporate Restructuring

While bank management, financial regulators, and macroeconomic policy came in for considerable discussion and criticism, many participants also called for greater focus on the problem of corporate restructuring. As some put it, the problem of non-performing loans is a reflection of the existence of vast numbers of "non-performing borrowers." Without creating a positive framework and procedures for improving corporate management, it was argued, even aggressive policies to eliminate deflation and to deal with NPLs would only have temporary effects.

In many countries, banks have served as key agents of corporate restructuring, as they have moved to protect the value of their loans to troubled companies. Participants agreed that this has strikingly not been the case in Japan, where banks

have often gone to great lengths to keep failing companies from collapsing by endlessly rolling over non-performing loans. While some participants saw hopeful signs – for example, evidence that banks were beginning to more clearly differentiate lending rates based on rating agencies' assessments of the health of borrowers – there was little sentiment that the basic role of banks in maintaining non-performing borrowers had changed.

Several factors were suggested as contributing to banks' willingness to roll over non-performing loans. An important one appeared to many to be the poor capital adequacy of banks, which meant that cutting off many non-performing borrowers and properly accounting for accumulated losses could result in under-capitalization of the banks themselves. Given that few banks would be enthusiastic about forcing their own failures, only outside force in the form of tougher oversight of loan classification, a major improvement in bank capital, or a combination of both would be likely to change the incentive structure. Only then would banks be a potent force for corporate restructuring.

A second obstacle seen was the long-term nature of Japanese corporate relationships. One aspect of this is that banks are reluctant to pull the plug on companies with which they have had a main bank relationship for years. Similarly, cross-shareholding among firms was seen to reduce shareholder pressure for change in management policies. This was partly because cross-shareholding creates a diffuse sense of responsibility, and because directors from affiliated companies may not advocate greater responsibility for fear of being held more responsible to shareholders themselves. Also, the long-standing practice of affiliated firms participating in bailouts may make it more difficult to pull the plug. Finally, much cross-shareholding is based on explicit – albeit not contractual – agreements between firms not to sell specific blocks of each other's stocks. When one firm wishes to sell another firm's stock, the other firm often attaches conditions on the sale such as who will buy it or how long it will be held by the buyer; this considerably reduces the extent of any market for corporate control that depends on unwinding of cross-shareholdings.

Given the difficulties of forcing – as well as implementing– restructuring, there was some discussion of how restructuring could be promoted. While it was generally agreed that this would be a task primarily for the firms and the banks themselves, some suggested a public sector role. One common suggestion was a more proactive role for the RCC in pushing restructuring at companies of which it has become a creditor – advocates stated that to date, the RCC has been hands-off in its management of its loan

portfolio, essentially offering an oversight reprieve to its debtors. The RCC could also contribute to corporate restructuring by more aggressively selling off its loans (even if at loss-making prices) at auction, bringing restructuring pressures back into the private sector. Some also suggested that the government (and perhaps the BOJ if it were to go ahead with its share purchase plan) could be more active in its role as a major shareholder in the city banks. A more reward-based proposal was for the Development Bank of Japan to provide preferential financing to firms that made active strides toward restructuring.

A final issue raised with regard to the problem of promoting corporate restructuring was one that was also raised at the Gotemba Symposium – the paucity of adequately trained and experienced turnaround specialists, or “armies of experts.” Some suggested more active training opportunities for raising the numbers. Others suggested that as demand for such expertise arose the supply would be sure to increase of its own accord; therefore, the key would be more RCC sales of assets.

Additional Policy Issues

Several more specific issues were also intensely discussed. The announcement by the BOJ only days before the Symposium of its intention to purchase stocks from commercial banks was particularly controversial. Despite the absence of details as to how the BOJ would actually implement the purchases, most participants were unconvinced as to their economic merits. They reasoned that there would be no meaningful benefit to purchasing the shares at market prices, but that many banks would be unwilling to sell their equities to the BOJ at below-market prices for fear of looking vulnerable. Meanwhile, the purchases could have a negative effect on the BOJ’s balance sheet, but without creating the benefit of quantitative easing. Also, having the BOJ picking among the stocks of various companies would have serious microeconomic consequences that quantitative easing through purchases of investment trusts would not.

The defenders of the BOJ plan stressed one of two points. Some urged participants not to pre-judge the plan until details had been made clear and there had been a chance to see how it would interact with the government’s own plans for dealing with recapitalization and NPL issues. Others argued that the announcement would have positive political effects, by stating implicitly that the BOJ did not believe that the

government was effectively addressing the problems of the banks. The Bank's surprise announcement might therefore shame the government into more proactive measures.

Another specific issue raised was the implications of the undersubscription of the JGB bond auction on September 20. A number of participants felt that this was a striking rebuke to the government that had grave consequences for the future. They argued that the basic cause of the undersubscription was the combination of the mounting Japanese government debt and a widespread belief that prospects for effective resolution of the problems of the banking sector were remote. The most pessimistic argued that this was an omen of a future in which the Japanese government would not be able to fund its deficits and in which there might even be capital flight by Japanese investors, suggesting a severe future hard landing.

In contrast to these dire interpretations, others argued that the undersubscription was a one-time event that simply demonstrated confusion in the marketplace, perhaps partly caused by the BOJ's surprise announcement only two days before. These participants saw no reason to expect a large-scale shift in Japanese investors' preferences away from JGBs or Japanese assets in general. They pointed out that Japan continues to enjoy large current account surpluses and pools of domestic savings, and that virtually all government debt is financed domestically. Moreover, they stated that the relatively low tax burden on the Japanese population suggests that tax hikes will be feasible in the long run.

Finally, it was pointed out that developments in postal savings and the Fiscal Investment and Loan Program could have serious repercussions for Japan. The postal savings system effectively competes against banks, but without limits on guarantees for depositors or having to pay deposit insurance. Depending on what form privatization takes, some participants felt that it was likely that competition between banks and postal savings would become even more unfair. Meanwhile, the vast hidden losses in the FILP were seen as contributing to Japan's long-term fiscal debt problem.

Information and Corporate Governance

Ensuring the quality of information and corporate governance was a major focus of discussions at the Symposium, given the general sense that both the United States

and Japan were experiencing a “crisis of corporate governance.” For the United States, key topics were the reliability of information available to shareholders and to the financial markets in general, and how to align economic incentives for managers and board members with the interests of shareholders. For Japan, these issues were seen as even more severe, given the prevalence of managerial leadership of firms with minimal input from shareholders. The Sarbanes-Oxley Act and the tougher standards of self-regulation prescribed by the New York Stock Exchange in the wake of the U.S. corporate scandals of 2001-02 provided a touchstone for much of the discussion. However, there was considerable skepticism about whether such disclosure rules alone could resolve all the problems of corporate governance in either country, or rebuild the lost confidence of investors in financial markets.

Quality of information was seen by participants as absolutely central to the smooth working of financial system. To maximize market efficiency, investors must have timely access to accurate and relevant information. However, making high-quality information easily accessible was recognized to be difficult and costly. One important issue was asymmetry of information access; as the recent U.S. financial scandals demonstrated, corporate insiders have better access to relevant information than investors and financial institutions, and are in some cases able to profit from that access at the expense of investors. Strict rules mandating disclosure and regulating insider trading have been a key response to this problem, but participants offered a variety of views on how those rules should best be written and enforced. A second problem identified was the cost of obtaining and analyzing information. This problem animated the discussion of how analysts’ incentives could be structured to provide objective and widely-available information and analysis.

Discussions were broad-ranging, covering disclosure, financial analysis, accounting standards, and the respective roles of management and boards of directors. Underlying most of the discussions, however, were concerns about economic incentives, conflicts of interest, and quality of information available inside and outside of firms.

Accounting Standards

There was considerable discussion of accounting standards over the course of the Symposium. These discussions focused on several separate but interrelated issues, including whether U.S. accounting standards had actually been problematic, how

accounting systems fit into broader national economic and regulatory systems, and whether global regulatory convergence was either attractive or possible.

Several participants argued that the strong media and governmental focus on strengthening accounting standards in the wake of scandals such as Enron and WorldCom was misplaced. They felt that the problem was not the standards and legal framework themselves, but rather that stock market bubbles always allow corporate misbehavior to be disguised during the boom, only to be dramatically uncovered after the euphoria is over. Others agreed that the standards themselves were not problematic, but argued that the accounting profession had not shown integrity in applying them or in regulating itself. Therefore, they saw Sarbanes-Oxley and the revised NYSE rules as important symbolic actions to demonstrate to investors the fundamental soundness of the system.

Among participants who saw important flaws in U.S. accounting standards, some concentrated on relatively specific issues (such as treatment of options), while others criticized the whole “rule-based” system as being particularly vulnerable to abuse. Several pointed out that a sub-industry has developed of accountants, lawyers, and financial professionals who come up with ways to evade the spirit of the rules while adhering to their letter. They argued that a system that depends entirely on meeting the letter of highly detailed laws is inherently vulnerable to misuse and that the current U.S. problems demonstrated the fallacy of earlier arguments by many U.S. experts that GAAP was preferable to the IASB “principles-based” system.

Opinion was split as to which system was better than the other, or if indeed there could be a single best system. A number of participants argued strongly that principles-based accounting puts too much confidence in the integrity of accountants. Given the real temptations faced by auditors (not to mention CFOs and comptrollers) to produce attractive pictures of corporate health, they felt that principles-based accounting would be even more vulnerable to misuse than rules-based accounting. A third opinion expressed by several participants was that neither could be made airtight.

A different tack was followed by a number of participants, who argued that an accounting system must fit comfortably with a country’s economic and regulatory systems, and perhaps culture. Legal frameworks were seen to be of particular importance. For example, in the United States, the prevalence of lawsuits and the potential of large punitive damages might make it important to firms and auditors to be able to demonstrate in court that they had clearly followed rules; the greater the latitude

for interpretation, the more uncertainty they would face in a courtroom situation. Elsewhere, the practice of administrative interpretation of codes without heavy judicial interference, as well as the lower toll of shareholder lawsuits, might provide a better fit with the principles-based approach. In such continental systems, the major issue would then be the quality of administrative oversight.

Among those who felt that convergence was not a likely or desirable outcome, a key concern was compatibility, or what one participant preferred to call “connectability.” The general point was that different national accounting systems and standards should all be measuring corporate performance in an honest way that can be understood by both domestic and foreign market participants. Practically speaking, this would mean general convergence around two or three systems (presumably GAAP and IASB). In terms of Sarbanes-Oxley, it would mean acceptance of auditing statements from any system that is well-regulated and discloses essential information.

Turning to more specific issues for the United States, accounting for options was perhaps the main focus. It was pointed out that one of the reasons that stock options have been such an attractive form of incentive pay for many corporations has been that they are much cheaper in the short run than awards of stock, at least partly because accounting standards have not required provisioning for them. Some participants argued that accounting for options as an expense would be a more honest method. Others objected that pricing of options is difficult, and that in many cases options could never be exercised because stock prices did not reach the strike price. Standards of tax accounting also complicated this issue. In any event, it was widely agreed that disclosure to shareholders of executives’ option packages would be appropriate, although some voiced skepticism that such information would have a meaningful impact on investment decisions.

While the U.S. accounting system came under heavy criticism from some participants, virtually all participants agreed that Japan had even more considerable problems. Several participants complained that consolidated accounting has yet to be fully adopted, making it difficult or impossible to know the overall health of a company. Incomplete adoption of consolidated accounting makes it relatively easy to bury liabilities, and these participants believed that there were substantial hidden liabilities among Japanese firms. More generally, there was a sense that Japanese accounting allows for substantial movement of liabilities off-budget.

Many felt that the general dissatisfaction with Japanese accounting standards created a negative risk premium on shares of Japanese firms. It might also weaken the global status of the Tokyo financial markets. Most participants thus agreed that, unless Japanese accounting standards and enforcement of standards are improved, foreign investors will be relatively uninterested in putting money into Japanese firms.

Impact of Sarbanes-Oxley

In general, participants were pleased with the accounting and disclosure reforms mandated by Sarbanes-Oxley. In particular, the principle of clearer responsibility for honest provision of information and greater accountability to shareholders received considerable support. There were some questions about how transferable specific provisions of the law would be, but many participants expressed a wish that Japanese authorities would also act to enforce the principles embodied in the law. They also drew a sharp contrast between the speed of the U.S. response and the slowness of Japan's.

While Sarbanes-Oxley generally received high marks from participants for addressing serious problems in the U.S. system of accounting and disclosure, several concerns were voiced about its effects. Particularly common were statements that Sarbanes-Oxley would not in itself be enough to restore investors' trust in the U.S. stock markets. According to this view, that process would take considerable time as well as energetic efforts by the accounting and financial industry.

Other participants were unhappy with the terms of the law itself. Some saw Sarbanes-Oxley as an overreaction to the situation. They argued that the market had actually proved itself to be self-correcting, with investors fleeing from firms whose business models they did not understand or whose official statements were seen as suspect. Given the self-correcting nature of the U.S. financial markets, they expressed concerns that putting strict new guidelines into law would only reduce the flexibility of self-regulation. (Some advocates of Sarbanes-Oxley agreed that it was possible that the law had gone too far in some respects, but argued that the law would be revised as any such excesses become clear.) A different version of the overreaction argument held that the scandals were far less endemic than was popularly understood, and that existing legal sanctions were sufficient to deal with the abuses that did occur.

Another reason for unhappiness with Sarbanes-Oxley was its international aspects. In particular, rules regarding the independence of auditing committees, along with certification of financial reports by CEOs and CFOs, were seen by a number of

participants as constituting extraterritoriality when applied to foreign firms trading in U.S. markets. As several pointed out, independence of auditing committees actually violates the Japanese Commercial Code, and thus creates an untenable situation for Japanese firms unless a waiver is negotiated between the U.S. and Japanese regulators. If no waiver is made available, several participants predicted that many Japanese – as well as other foreign – firms would de-list from U.S. exchanges. (Even with a waiver, some felt that stricter rules would make listing in the United States less attractive.)

Widespread de-listing would create two problems for U.S. markets – it would reduce business for U.S. exchanges, and it would increase the number of firms not subject to rigorous disclosure and accounting rules. Others felt that large-scale departures from U.S. exchanges would be highly unlikely. They reasoned that the size and importance of U.S. capital markets would continue to draw foreign firms. Also, the strictness of U.S. rules might be reassuring to investors around the world, making a U.S. listing a sort of quality stamp.

A final concern about Sarbanes-Oxley's extraterritoriality had to do with accounting standards. Some echoed fears that had been published in the media over the summer that the requirements for financial report certification might be a subtle way of promoting the U.S.-style "rules-based" accounting system over the "principles-based" system preferred internationally. Although the new rules mandate U.S. approval of home-country accounting statements, others predicted that the SEC would be sensitive to other countries' accounting systems in applying them.

In a different vein, some participants pointed out that Sarbanes-Oxley calls for certification of accounts by the CEO and CFO of the firm. In Japan, there is no legal category for either CEO or CFO, and that in many cases CFO responsibilities are dispersed among several different positions in the company. While some saw this as a serious problem for the application of Sarbanes-Oxley, others felt that it was a minor issue that would easily be solved through negotiation of a reciprocal understanding between U.S. and Japanese regulators.

Lessons from U.S. Experience

Many participants felt that the recent events in the United States carried important lessons for Japan, and criticized statements in the Japanese media that the U.S. scandals meant that Japan should ignore calls for U.S.-style standards of accounting and disclosure. It was widely believed that there are many examples of

Japanese corporate malfeasance as extreme as those of Enron and WorldCom that are still being hidden by acquiescent auditing committees. A perhaps even more important lesson that many felt could be drawn from U.S. experience was the importance of acting rapidly and assertively to deal with failings in the system. They contrasted the rapid response of the U.S. Congress and the New York Stock Exchange with the glacial pace of reforms in the dozen years since the bubble began to burst, and encouraged Japanese policy makers to move quickly now.

Participants were supportive of attempts to inject new rigor into the system. One proposal that was attractive to many was the establishment of a strong and independent Japanese Securities and Exchange Commission, separate from the FSA, staffed by officials with specialized knowledge of finance and accounting. Most agreed that much larger numbers of highly competent regulators would be needed to enforce stricter rules. With regard to auditing, there were significant concerns with the current system of peer review, and some felt that a formal oversight board might be necessary.

Disclosure

Going beyond accounting *per se*, another major topic of discussion was disclosure more generally. A number of participants bemoaned the lack of a rule of prompt and “fair disclosure” of material changes in Japan. Instead of being forced to immediately disclose such changes, Japanese firms have the option of disclosing them only in quarterly or semi-annual reports. Three potentially serious problems were seen to result. First, firms can engage in selective disclosure, releasing good news as soon as it appears, but holding off bad news until the quarterly report (by which time it is seen as “old news”). Second, in order to get access to internally-held information about material changes, analysts are forced to try to cozy up to executives, which might compromise their independence. Third, the expectation that Japanese firms may be concealing negative information makes them less attractive to investors both inside and outside Japan. In order to eliminate such selective disclosure problems, these participants advocated the immediate adoption of a “fair disclosure” rule in Japan.

While most participants seemed to agree with the principle of timely and fair disclosure, some raised questions about the quality of information that is released before all the facts are known. In other words, they felt that there was a trade-off between speed and quality of disclosure. For these participants, the quest for real-time disclosure was a potentially dangerous idea that could contribute to stock market volatility and lack

of confidence in corporation. They called for a standard that would allow corporations at least some time to confirm material changes, and also warned that reducing time for release of accounts could pressure accountants into putting less thought in the process rather than seriously thinking about the most accurate and efficient way to present financial information. One additional caution that was offered was that every new disclosure requirement adds to the costs of doing business, so governments and oversight bodies should not be too quick to impose new requirements.

Surprisingly, some participants argued that investor confidence in published information is higher in Japan than in the United States. While many disagreed with such statements, one reason given for why it might be true was that, due to speedy disclosure rules, U.S. firms have to make so many announcements that they later revise. Alternatively, U.S. investors may just have been more recently disillusioned than their Japanese counterparts.

Managing Conflicts of Interest

While the rules of accounting and disclosure were central to the discussion of the quality of information in financial markets, some participants argued that improving the way information is produced is of profound importance in improving its quality. In particular, they focused on conflicts of interest faced by both corporate insiders and financial analysts.

Analysts

Given the focus on information flows in the market, a great deal of attention was paid to analysts. Most importantly, many participants felt that analysts' incentives were skewed heavily towards promoting companies rather than providing objective analysis. They argued that the most important negative influence on analysts has been that in most cases they are paid not by the consumers of their analysis, but by investment banking divisions. Since investment banking divisions are most interested in attracting clients, they were seen to prefer that analysts give positive assessments of actual or potential clients. This sell-side bias was seen to be pervasive throughout the financial services industry, although it had been most obvious in the dot.com and telecom bubbles.

In addition to pressure from investment banking divisions, other sources of pressure on analysts were also seen as problematic. In Japan, some said that regulators have pressured analysts not to downgrade weak firms and financial institutions, for fear of reducing banks' capital positions. There was some dispute about how prevalent this was or whether it existed at all, with several analysts saying they had never been pressured by the FSA. However, others suggested that while foreign analysts (or analysts at non-Japanese financial institutions) might not be pressured by the FSA, Japanese analysts were more likely to be since FSA might hold more power over them and their parent institutions. Another source of potential conflict of interest was mutual funds that took large buy-side positions. One U.S.-based analyst told of funds that had withheld trades from the analyst's firm following negative reports on stocks in which the funds held large positions. Again, it was unclear how prevalent this was, although it would clearly reinforce the general problem of conflicts of interest.

An alternative point of view was offered by some analysts who argued that the sell-side bias was not really important. They asserted that experienced analysts traded on their reputation, so they would not skew a report just to satisfy the short-term needs of their current employers. Moreover, although they agreed that "buy" and "sell" recommendations were often excessively positive, they claimed that informed investors read the analysis itself, and do not buy or sell based on the recommendations of analysts. Also, they asserted that such recommendations were largely meaningless anyway, since investors have widely varying time horizons. Opposing this point of view were participants who said that, while sophisticated investors could ignore recommendations and effectively make use of the actual information and analysis in a report, unsophisticated (retail) investors often took such recommendations seriously. They suggested that the main effect of overly positive recommendations was to fool retail investors into making inappropriate investments.

With most participants seeming to agree that a credibility gap had appeared due to conflicts of interest, there was considerable discussion of possible remedies. A number of participants felt that the recent U.S. rules requiring analysts to reveal the track records of their recommendations on their reports were a good start. Others were less pleased with the rule, pointing out that it violated the basic principle that "past performance does not guarantee future success." They also argued that the required format was too crude to adequately grade performance in any event, since it ignored the differing time horizons of various categories of investors and it measured success

against an arbitrary benchmark. Supporters of the rule argued that, since everyone else in the financial world was evaluated based on track record, it seemed odd that only analysts should be excepted. With regard to the issue of inappropriate benchmarks, they pointed out that nothing prevented analysts from including additional tracking that the individual analyst considered more appropriate, such as providing a longer timeframe or a different benchmark.

A number of participants argued that more fundamental reforms would be necessary to eliminate analysts' incentives to maintain a sell-side bias. One of the most basic of these was to have strict restrictions on analysts owning and trading in securities of firms that they cover. In keeping with the concerns over conflicts of interest, a more ambitious approach was to change the whole structure of compensation for analysts. A number of participants argued that objective analysis would only be possible if analysts were not paid by investment banking divisions. Others objected that, however attractive this might sound in principle, it was not realistic to expect consumers to pay analysts directly; indeed, they asserted that analysis has generally been a money-losing operation in and of itself, and that financial institutions only provide it as means of drawing in clients.

Thus, the problem remained of how analysts could be compensated without making them subject to investment bankers. Some argued that it might be more appropriate for them to work directly for large buy-side institutions such as hedge funds, but it was not clear how this would address the need of retail investors for quality analysis. Recognizing the "public good" nature of information and analysis in financial markets, some went so far as to suggest a Wall Street consortium or some sort of public funding mechanism. Most participants did not seem to find this idea convincing, arguing that the actual mechanisms of funding the consortium, evaluating analysts, and determining pay levels would likely be insurmountable.

While most of the discussion of financial analysts focused on U.S. markets or on foreign institutions in Tokyo, many participants argued that the problem is even worse in Japan. They felt that Japanese analysts are heavily pressured by their employers and by their contacts in the companies they cover to avoid negative news. As in the United States, it was not clear how the problem could be addressed most effectively, but there was considerable support for some sort of objective grading system for analysts that would allow investors to make more informed choices. Echoing the discussions about accounting and disclosure rules, many participants pointed out that as long as analysts'

reports are considered untrustworthy by investors, investors would also be reluctant to purchase Japanese securities. Thus, there would be important benefits to be gained by improving standards.

Corporate Boards

Conflicts of interest were also seen to be rife in corporate boards and auditing in both Japan and the United States. Many participants considered this to be of central importance in restoring confidence in financial markets and restoring economic growth. This was not purely an issue of ensuring the provision of accurate information in financial markets – which is critical to efficient allocation of capital – but also of the way corporations are run.

In posing the problem, participants cited theories of corporate governance that call for boards to be representatives of shareholders, whose main job is to oversee the activities of managers and to provide shareholders with accurate information about the condition of the firm. This ideal of the independent board of directors has clearly not taken hold in Japan, where very few boards have even one or two truly independent directors, let alone a majority. Many participants linked the lack of board independence with a tendency to manage companies for the sake of managers rather than shareholders, which they said had contributed to Japan's economic malaise and proliferation of "non-performing borrowers."

In contrast, some participants felt that introducing independent U.S.-style boards in Japan was likely to be counterproductive. One reason given was the long-term nature of employment in Japanese firms, which meant that shareholders have to be sensitive to the sentiment of managers and employees in order to maximize productivity. Similarly, long-term relations among suppliers and customers might make representatives from related firms more appropriate than fully independent directors who might disturb the internal and external ecology of the Japanese corporation. Also, some participants suggested that the long-term nature of employment meant that managers were likely to be far more knowledgeable about the firm and its working than outsiders – although other participants countered that this was the very reason for having a strong, independent board. A final objection to a wholesale switch to independent boards was a perceived lack of expertise – several participants expressed skepticism that thousands of competent and energetic outsiders with real stature could be found in Japan in the near future, given the lack of a tradition of board independence.

A further problem has been the lack of a meaningful market for corporate control in Japan. Hostile takeovers have yet to be successful, despite promising signs such as the proxy fight over Tokyo Style. Without a serious threat of takeover, several participants argued that it would be impossible to discipline managers who ran firms for their own benefit rather than that of the shareholders. It was pointed out that an additional problem that weakens markets for corporate control is the ambiguous legal status of voting rights for shares held in trust – in some cases owners vote the shares, while in others trust banks do so. There might be very little incentive for trust banks to enforce better corporate governance, given their dependence on business from firms whose pension funds and other accounts they manage.

While the situation was particularly striking in Japan, a number of participants questioned whether “independent” U.S. boards of directors were actually very independent. They pointed out that board members are often selected by management and then presented for approval to shareholders. Even large institutional investors that have proclaimed themselves to be deeply concerned with corporate governance were seen as seldom exerting their powers in the selection of directors. Moreover, many directors of U.S. corporations also do business with the corporations of which they are board members – again, based on decisions by management. Director’s insurance, which is often funded by the corporation, might further reduce incentives to question management. Thus, these participants felt that CEOs (who are often also board chairmen) could generally shape boards to support their own agendas. On the other hand, others argued that the very real possibility of corporate takeovers – and thus a market for corporate control – meant that boards had a substantial incentive to behave in the shareholders’ interests.

Audits

The problem of board independence was also seen to have considerable relevance for the quality of financial information available to markets. The basic issue is that audits are carried out by accounting firms that are hired by the corporations being audited. This opens up the possibility that accounting firms will tailor their audits to satisfy the corporation – a possibility that many participants felt had been confirmed by the various accounting scandals in the United States. The key issue then would be how to reduce this basic conflict of interest.

Many participants agreed that having higher standards of independence and competence for auditing committees would be an important step in improving the objectivity of audits. Most were enthusiastic about the new requirements in Sarbanes-Oxley and in the rules promulgated by the New York Stock Exchange increasing the level of shareholder control over audits. There was also considerable enthusiasm for the Sarbanes-Oxley rule making American CEOs and CFOs personally responsible for the accuracy of their financial statements. Increased public oversight of accountants through the new Public Company Accounting Oversight Board, which replaces self-regulation by the accounting profession, was also seen by many participants as a positive move.

Nonetheless, some felt that the basic conflict of interest would remain as long as auditors are hired by the corporation being audited. They argued for provisions that would limit corporations ability to collude with accounting firms, such as enforced rotation of accounting firms or even public funding of corporate audits. However, most participants appeared skeptical of the benefits of introducing such a level of government interference into the accounting profession.

In general, participants felt that Japan had much to learn from the United States in promoting objective audits. At the level of the firm, even those who were skeptical of U.S. standards of board independence were concerned about the way that audits were handled. They felt that by leaving the responsibility of auditing to a *kansayaku* (auditor) who is neither on the board of directors nor independent, there was little chance of auditors contradicting the wishes of management. (It was stated that in most cases, appointment as *kansayaku* has been a consolation prize for senior managers who have been passed over for promotion to the board – which accentuates their subordination to their manager/director bosses.) It was not universally agreed that an independent audit committee was the answer, despite the apparent extraterritorial reach of Sarbanes-Oxley for corporations listing in the United States, for reasons discussed above regarding board independence. However, there was strong sentiment for giving more independent responsibility and resources to a board-level auditor or auditing committee.

At the public sector level as well, participants felt that Japan should learn from the United States. The lack of an independent SEC with comprehensive jurisdiction over Japanese capital markets was a problem cited by many. Not only are Japan's regulators subordinate to other ministries and agencies, but their functions are fragmented among several agencies (including FSA, SESC, and MOF regional bureaus). The issue of

independence also arose with regard to oversight of accountants, whose self-regulation was seen to reinforce considerable conflicts of interest. In this regard, the U.S. example of a strong SEC (further strengthened by Sarbanes-Oxley) and the new accounting oversight board (private sector, but with government oversight) were seen as an attractive model for Japan's own capital market regulation and auditing oversight.

Corporate Culture and Investor Education

While much of the discussion of corporate governance and information disclosure dealt with standards, incentives, and oversight, some participants argued that changes were equally needed in the mindsets of corporate officers, accountants, and investors in both countries, but particularly in Japan. This took several forms. Looking at the willingness of many actors to follow their economic incentives rather than their consciences, several participants argued that it is of central importance for corporations to reward integrity in addition to objective measures of performance. They felt in particular that senior management set the tone for the firm as a whole, and that even strict rules and penalties could not ensure integrity without a strong example being set at the top.

In this regard, some participants were concerned with certain aspects of Japanese corporate culture. They felt that the practice of long-term employment with relatively few exit options created a situation in which individual employees would suppress their own ethical standards for the perceived good of the company. Some offered the example of the treatment of whistleblowers, pointing out that they not only face resentment inside their companies, but also that there are no legal protections to prevent them from being punished for revealing embarrassing information. (The point was also made about government officials.) They argued that it would be necessary for Japanese employees to develop a concept of corporate ethics that extends beyond the interests of their organizations.

With regard to investors, a number of participants called for better investor education. For example, it was suggested that if investors knew that analysts were working for the sell-side, they may have been less willing to simply accept recommendations at face value. Better investor education seemed particularly important in Japan, where a majority of the population remains leery of the whole concept of investing, thus keeping their savings in banks. If investors were to demand better management of corporations, several participants felt, Japanese corporate governance

would benefit considerably. Some even argued that corporate governance should be of such importance to investors that it would be helpful to construct a widely-accepted index comparing corporate governance across companies and across countries, which investors could use in allocating their money.

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