

Securities Industry Executives Speak Out

By Brian Robins

The boom in world share markets over the past 18 months, combined with the increasing securitization of debt, has resulted in an increase in the number of foreign securities companies moving to establish themselves in Japan. The number can only increase in future. The lure of operating in the securities industry is such that some foreign banks, for example, American Express, have decided to surrender their banking licenses in favor of increasing securities operations in Japan.

As a result, there are now over 140 foreign securities companies with either representative offices or branches in Tokyo. So far, only a limited number of foreign securities houses have direct access to the floor of the Tokyo Stock Exchange (TSE), although more will certainly join them before long.

The *Journal of Japanese Trade & Industry* spoke recently with the heads of the four leading foreign securities houses to get their views on operating in the Japanese market.

TSE Membership Pays Off

David S. Phillips, managing director and general manager, Morgan Stanley & Co., Inc., Morgan Stanley International Ltd.

Q: *What were your reasons for becoming a member of the TSE?*

A: Becoming a member of the TSE was tangible evidence of our commitment in Japan. We are members of the New York Stock Exchange and we claim to be a global firm, meaning we operate in Tokyo, London and New York on a 24-hour basis. Therefore, becoming a TSE member was very important.

Q: *What are the costs involved in TSE membership?*

A: One is the entry fee of ¥1.5 billion. That was a necessary initial investment. We are in the business of not losing mon-

ey, and therefore we must constantly think of revenue and expenses. However, membership has more than paid off.

We have to follow the U.S. practice of building up our own research capabilities. We are authorized to build up a team of eight members here and we have achieved a little over half that target number. In this country it is pretty hard to find people.

Q: *Have you found it easy to do business with Japanese institutions?*

A: Not easy, but quite promising and rewarding so far. However, we have some unique means to gain clients. Even in the U.S., we have only three branches, meaning that internal communications are excellent. By the time we open in Tokyo, many of our staff have been in contact with New York and London. Our prompt, accurate information is vital to decision makers here.

Q: *But don't the Japanese securities houses get the same information from their overseas offices, and also immediately inform their clients here?*

A: Yes, but we concentrate on corporate accounts and institutional investors. We have built up long-term relationships with many institutions in the investment banking area, and are able to offer accurate, quick service with our own analyses, together with competitive rates and quick execution. We constantly come up with new products or new ideas of analysis.

Q: *Have you been surprised by the speed with which you have been able to do business with Japanese institutions?*

A: No, both the business we are getting and our manpower requirements are more or less as I had planned. But it will take years before we can claim we have deeply penetrated the market. Our main concern is to determine in advance which trend the Japanese are shifting to. Therefore, we encourage our people to wine and dine potential customers—we cannot afford to miss such opportunities. I think Japanese are two faced and there is a real dichotomy between form and substance. In the evening, you are better able to get some substance out of people, including

government officials, if it is supposedly on an informal basis.

Q: *Where is the major growth occurring in your business?*

A: I think the sharpest growth is taking place in sales and trading. To me, equity and fixed income are two areas that will grow more as time goes by. Another growth area is investment banking.

Q: *How do you define investment banking?*

A: It includes all financing issuing business, swap activities, real estate, mergers and acquisitions and all the rest.

Q: *Will mergers and acquisitions increase in the future?*

A: Not in any significant way. We have been the most active in that field compared with other investment or commercial banks. We have acted, with one exception, on behalf of Japanese entities acquiring U.S. institutions. We have two full-time mergers and acquisitions specialists on our staff. It is no longer taboo in Japan to acquire companies, but I don't think we will witness the same type of mergers and acquisitions that have been occurring in the U.S. anytime soon.

Q: *Compared with the other foreign securities houses, how do you rank in terms of turnover?*

A: In the equity area, we overtook Jardine Fleming last July, and ever since we've been number one. In terms of the percentage of the total market, we are ranked 30th out of 93. We intend to be 20th by the end of this year. But beyond that, it is going to be tough, because the big four hold 40% to 45% between them.

Q: *What would you need to topple them?*

A: We would need a retail operation, but that's not what we have in the U.S. and I wouldn't recommend doing that here.

Q: *How do you see your operations broadening over the next few years?*

A: I'd like to add a few new products, but our main revenue source will come from expanding what we have today. The target for 1987 is to expand our clientele, so that we can ride out ups and downs in the market.

Q: *How have you found the competition from the Japanese houses?*

A: They have been friendly competitors, because we have not become a threat to them yet.

Q: *How can the Tokyo capital market achieve its full potential?*

A: I've been hearing about the internationalization and liberalization of the Japanese financial market for some time, but what we've witnessed is only the tip of the iceberg. It is true that the Ministry of Finance has deregulated some areas in the past two years. But true liberalization has yet to come.

Q: *Is that impeding the growth of Tokyo as a financial market?*

A: The basic problem is the present set-up for government bonds. They take top priority, with dictated terms and so on. Unless the Ministry of Finance restructures that area, I don't think Tokyo can remain one of the top three world markets.

A Forte in Research

David Miller, director and general manager, Jardine Fleming (Securities) Ltd., Tokyo Branch

Q: *What are the differences between your initial expectations and actually trading with direct access to the floor of the TSE?*

A: Although we tried to do a lot of work on the computer systems side, it has proved more complicated than we had originally thought. The settlements system in Japan is archaic in the extreme and needs a major overhaul. This is planned for early 1988, when computerized settlements will start. I only hope that they will take into account problems of international trading when they do go over to the computerized system. Such problems, and the costs associated with them, have been larger and more time consuming than we had thought they would be.

Q: *Why did you seek stock exchange membership?*

A: Definitely one reason was the prestige associated with being a member of the right club. We are more than pleased with the reception we have had. We find it easier to hire people, particularly new graduates. People now feel we've got roots in Japan, that we're not just a *gaijin* company that may fire all its employees tomorrow.

As far as actual trading in the market

has been, I don't think anything has been particularly different from what we thought it would be. As a branch we continued to pay commission to Japanese brokers and members, but it reached the point where the services that were supposed to be the reciprocal of those commissions were deteriorating pretty fast as they came to see us as a source of serious competition.

Q: *Is it now easier to do business with Japanese institutions, or is there still an element of wariness?*

A: I don't think there is an element of wariness. There is still the question of how much more we can offer than a Japanese broker can, however. Most fund management institutions are over-broked on the Japanese side. A *gaijin* broker must offer something special or different. Just being a TSE member gets you in the door, but it doesn't bring you clients. You've got to work hard on that by offering new products or new angles on things. Trading alone isn't necessarily the key.

Q: *What sort of new products or new angles can you offer?*

A: We are selling Europroducts in Japan, mostly of a convertible or warrant type, and this year we have started selling U.S. treasuries and U.S. equities. In addition, we believe we have an international research team, with 35 analysts in New York, 20 in London and by next year we hope to have approximately 20 here. In some companies, the analysts are isolated, or are mainly concerned with writing long-term reports instead of analyzing today's activities. Flemings bought a medium-sized American broker called Everstadt 18 months ago, with 35 analysts covering technology shares, health care services and chemicals. This fits in beautifully with general technologies here, as well as with health care and drugs, a fast-emerging type of industry, and it also fits with the more mature chemicals sector.

Our analysts spend some time in the U.S., and the analysts there come over here. We really do get thorough exchanges of information. Five years ago we could advise people to buy NEC without ever having visited the U.S. But you can no longer advise people about NEC unless you know what IBM is doing. The world has become more sophisticated and investors require more sophisticated services. Thus exchange of information is very important. I think that in some of the larger firms such exchanges are quite difficult.

Q: *Is that your forte in this market?*

A: Yes. We sell U.S. treasuries and equities and we have a good research

product. In the Japanese main product line, what we have is an international view of stocks. The Japanese brokers say that they have an international view but they don't—they really don't know what is happening in the U.S. and therefore can't form an international view. We also have bilingual analysts who not only travel to the U.S. but can go to companies and talk to clients here in Japanese.

Q: *What comprises the major part of your business—equities or bond trading?*

A: It's equity trading right now, but I see the balance shifting toward bond-type instruments and foreign instruments. Historically, our business has been 90% selling equities to *gaijin* around the world. That has changed because we are selling Japanese equities to Japanese investors and foreign equities to Japanese. At the same time, on the bond side, which we started to develop in 1983, we are now one of the significant foreign players in the Japanese bond market. Linked in with our Euroconvertibles in London, we are probably the biggest market maker in Japanese Euroconvertibles and warrants, and we also sell those back into Japan. We are a small player in U.S. treasuries, but we do make money out of them and they are a necessary product.

The balance will shift away from the *gaijin* client base and away from a pure equity base. I think in three or four years, our Japanese client base could be the same size as our foreign client base. I don't see why half our money should not be made in bonds and half in equities.

Q: *What has been easier since you have had direct access to the floor of the TSE?*

A: Dealing has been better, and our information flow back from the floor has been much better. We have very short lines of communication. If you go to a Japanese broker, you'll find the international marketing department in one building, the trading room in another building and then there is the trading floor. Our traders are sitting three meters from our sales staff. Thus we have not only rapid feedback of information, but the ability to deal quickly and efficiently.

Q: *Are your operations profitable now?*

A: Yes, they are. How much money we'll make this year is a question, because commission rates for us have fallen, depending on the structure of business, by some 20% to 25%. But I think there are extra reasons to worry about profitability this year. First is because of commission rates; second because costs have gone up by a significant amount this year due to the inflationary bull market in people.

We have a steadier house than most

and have been here longer, so we don't find it quite so hard to tempt people through the door and we don't have to offer outrageous salaries. However, we still have had our problems and have lost one or two people. These factors make me worry about profitability in the next year.

Q: *Is a Japanese-style Big Bang appropriate for the future development of the Tokyo capital market?*

A: I think Japan has to accelerate the process of liberalization. The Japanese see it as going along quite nicely, but everyone else in the world sees it as going too slowly. Japanese institutions cannot continue to take full advantage of all the cultural openness of world markets while blocking the entry of foreign institutions into Japan. It's just not feasible in the modern world. At the same time, Japan has a huge balance of payments surplus, which everybody is criticizing it for. This could lead to protectionism worldwide. Of course, Japan is unwilling to change its systems when it's in such a strong position. The danger in Japan is that every move is made step by step. The whole decision-making process here is so cumbersome, and the factional interests so strong, that every decision is a consensus decision, not a courageous one. That is bound to cause problems. If nobody can change the process, Japan will be hurt and so will everyone else.

Q: *Is the lack of adequate futures and commodity markets limiting the full development of Japan's capital markets?*

A: Yes. It is very hard to go short on anything in Japan. The short-term capital market is pathetically underdeveloped for such a large bond market. The whole syndication system is crazy in Japan, not only for keeping foreigners out, but for raising money so expensively. It can't be in the government's interest to continue that. I'm not asking for Japan to change overnight, but so far Japan has not taken any courageous actions to facilitate the needed changes.

Deliberate Growth

John A. Williams, president, chief executive officer, Merrill Lynch, Japan

Q: *What is your main client base?*

A: Our main client bases in the capital markets end of the business are corporations and financial institutions. It isn't much different from the client base in the Chicago institutional region. The main difference is probably that corporations in

Japan are such large investors of capital on their own accounts, whereas corporations in the U.S. basically use short-term money market instruments and certainly never invest in equities on their own accounts. Corporations in Japan have historically traded in equities, bought equities and held them for long periods of time. Therefore the corporate investor is a really important factor in Japan's capital markets in terms of sales and trading.

I don't foresee our client base changing very much, but I do foresee us becoming able to sell yen products, which we can't do now, to a lot of that client base.

Q: *Have you been pleased with the growth in your equity trading?*

A: We have embarked on a program of deliberate growth. In the eight months I've been here, I have formed the judgment that from a long-term standpoint we must expand our yen equities business with Japanese investors, and even with U.S. and European investors, by developing effective research and trading and sales capabilities. To break the grip of the big four we must have value added from research and a trading force to back up the research and sales efforts. In my opinion, the yen equities business of foreign firms with Japanese investors is now where the U.S. equities business was 10 years ago, that is, it is really research sales business. We have nine analysts now plus one full-time economist. We'd like to double that number in the near future, but it's tough to get analysts in Japan who do American-type analytical work.

Q: *How valid is it to rely on research for the growth of your equities business in an easily manipulated market like that in Japan?*

A: That's a good question. It's a different kind of equity market, but we believe the client base in Japan will lean more toward the U.S. way of operating since they're buying more U.S. equities now.

Q: *How will Merrill Lynch develop over the next 10 years?*

A: If I knew, I would be a happy man. Presuming that Japan will remain a very large supplier of funds, we hope to grow dramatically. It's going to be a big business here, and we all want to be part of it, but not everyone is going to survive.

Q: *What is the main orientation of your business—institutional or retail?*

A: It's institutional. Let's call it capital markets, because Merrill Lynch Japan does pretty much everything the New York office does, only in a very small way. We have built a business here that is not only institutional in terms of sales and trading, but is also focused on capital markets in terms of investment banking,



mergers and acquisitions, operations and so on.

Historically, in the international arena Merrill Lynch has sold U.S. products to foreign investors in their home locales. We're still trying to do that, but we're also trying to be more effective in selling local products to local investors. That's a tough business for us and our competitors, since the big four in Japan occupy such a significant role in all aspects of our business. In the U.S., no four or five firms really dominate any section of the market. So that's a tough nut for us to try to crack here.

Quality Over Quantity

Christopher T.B. Purvis, branch manager, S.G. Warburg Securities (Japan) Inc. Tokyo Branch

Q: *Have you been surprised by the development of your operations in Japan?*

A: When I arrived here nearly five



The IMAGE BANK. Photo by Brett Froomer

The Tokyo Stock Exchange seethes with active traders.

years ago our office was a representative office. There were no great expectations of developing a full-fledged securities or investment advisory operation, so the reality has been far beyond our first expectations.

In December 1984 we obtained our securities branch license and we started operating as a branch the following January. We became members of the TSE on February 1, 1986 and started trading on June 3. One of the interesting things about Japan is that when one makes a change in business character or a change of status, there will often be a lot of side effects. In many ways things have a symbolic nature in Japan that they don't necessarily have anywhere else. By moving from a representative office to branch status we found that there was a real change in people's attitudes toward us.

Q: Has that made it easier as your operations have matured here in terms of doing business?

A: Yes, it has made it both easier and more difficult. Running an operation with 100 people brings with it its own problems in any country, and perhaps

there are particular problems relating to Japan. Generally speaking it is easier, and we are able to do more now than before.

Q: What advantages can you offer your Japanese clients?

A: It depends on the business, but I would say we try and combine two rather contradictory elements. On the one hand, we are extremely international—not just foreigners, but international. At the same time, I like to think that we are also Japanese, so that we bring to our Japanese clients an understanding of the way their operations work, whether it is in investment or borrowing. These are the two aspects we are trying to develop.

In equities trading, we are very active in research, selling and trading activities in all major markets of the world. The Japanese houses have their own strengths in this market as traders, but they are first and foremost Japanese houses and are not developed properly internationally.

We do a lot of business with Japanese investing institutions, corporations and semigovernmental bodies. We were recently appointed by the Life Insurance Bureau of the Ministry of Posts and Tele-

communications as one of their four dealers. Of the six foreign houses on the TSE, we are ranked around fourth. We believe that quality is important; simply having the largest volume is not necessarily the best.

Q: How long will it take before you achieve your optimal size in this market?

A: I would hope that in a year from now we will have the resources to offer the best services.

Q: What constraints limit your expansion?

A: There is very little we want to do in Japan that we currently cannot do. There is one particular area where there will be change, however, and that is in the granting of licenses to act as discretionary managers. We will welcome that change. In the long term, there is logically no difference between pension funds, investment trusts and other types of portfolios in investment management. At present, the three are split. This is, in our view, an artificial distinction.

Q: With the rapid growth in the number of foreign securities companies setting up offices in Tokyo, do you think that the market will go through some form of shake-out?

A: There are a lot of people opening branches here, and not all are clear about what they will do if the domestic equity market goes down. Generally shake-outs are a bad thing. There has been a lot of talk about the likely shake-out in the U.S., and that may have repercussions here.

Q: Does the Japanese market need to go through a Big Bang?

A: It depends on what you mean by a Big Bang. A Big Bang is now used to mean many things. What it meant on October 27, 1986 was that brokers in London were able to act in a dual capacity both as agents and as principals and it meant the start of negotiated commissions. Brokers in Tokyo are already acting in a dual capacity, so that aspect doesn't count.

Q: Does Japan need to have negotiated commissions?

A: That is a difficult question. I think as Japanese institutions deal more and more in international capital markets, they will become more and more used to negotiated commissions. Surely they're going to want to negotiate commissions in their own market.

Q: Does the Tokyo market need more liberalization?

A: I don't think it does, but I think as the distinction between domestic and international markets disappears, liberalization will occur little by little. ●