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Daiwa Bank Scandal in New York: Its Causes, Significance, and Lessons in the International Society

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ABSTRACT

The New York Daiwa Bank scandal, which involved Daiwa Bank's concealment of $1.1 billion in losses from the illegal funding of U.S. Treasury bonds and the diversion of another $100 million in losses incurred by Daiwa Bank Trust Company, resulted in the most severe economic penalties ever imposed by the United States against Japan. These penalties included the termination of Daiwa Bank's U.S. operations and the reinforcement of the increased rates at which Japanese banks can borrow U.S. currency—the "Japanese premium." In addition, the Daiwa Bank case substantiated an international distrust of Japanese financial institutions, which are closely aligned with their governmental regulator, the Ministry of Finance. Despite the internationally-based opposition to Japan's regulatory and banking practices, Japanese authorities view the retaliatory steps taken by the United States as excessively harsh.

In this Article, the author compares the differing United States and Japanese reactions to the New York Daiwa Bank scandal on legal, economic, and sociological levels. Based on

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†Editor's Note: As a service to our readers, the Editorial Board normally checks cited material for both "blue book" form and substance. This article, however, relies extensively on sources available only in Japanese. These sources are identified in the first full citation as "Japanese-language source." The Editorial Board has not translated these sources and they have only been checked for "blue book" form.

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his analysis, the author concludes that cultural differences between the United States and Japan lie at the heart of the scandalous proportions of the Daiwa Bank incident. Furthermore, the author believes that the Daiwa Bank case offers an important lesson for Japanese companies with international operations: "When in Rome, do as the Romans do." According to the author, Japanese banks and other industries will eventually earn the trust of the international market by abiding by foreign laws and improving Japan's regulatory practices.

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I. INTRODUCTION

An incredible incident was disclosed recently at Daiwa Bank's New York Branch: one of its employees had been illegally trading U.S. Treasury bonds for over eleven years without detection, causing the bank an accumulated loss of $1.1 billion. Since then, this incident has mushroomed into an international scandal, resulting in civil, criminal, and administrative liabilities in both the United States and Japan. There has never been an economic incident with such a tremendous international impact between Japan and the United States.

The concerns about the incident expressed by supervising authorities of both countries, as well as by stakeholders, such as corresponding foreign banks and the Bank's stockholders, resulted in specific actions being taken to manage the situation in its aftermath. Those actions, in return, caused further questions on both sides of the Pacific. It seems that all of these opinions, actions, and questions stem from the differences in Japanese and American social systems and thought patterns.

For example, Daiwa Bank (hereinafter Daiwa or the Bank) and the Ministry of Finance (hereinafter MOF), the authority within the Japanese government that supervises the Daiwa Bank, do not acknowledge any fault in the matter despite the fact that the incident drew severe criticism internationally and caused Japan to lose credibility. Why? Is there really a difference in the legal systems of the two countries that makes an act illegal in the United States and legal in Japan? Are there any conceptual differences between the systems of the two countries as to a corporation's responsibility for the disclosure of important information regarding its performance?

In addition, the mutually supportive relationship between the Japanese government and Japanese industry—often called the "convoy" system—has long been accepted by the people of Japan. The rest of the world, however, has become more suspicious of this relationship. Accordingly, the Daiwa incident caused the MOF to lose its credibility as a competent authority in the eyes of international observers. Is such a relationship unacceptable in international society? Does the MOF need an overhaul?

Furthermore, Japan disapproves of the retaliatory steps taken by the United States. For instance, the U.S. Federal Reserve Board (hereinafter FRB) has ordered Daiwa Bank to cease its operations in the United States. Some in Japan considered this action to be too severe. What caused this decision by the FRB? What are the legal grounds for it? The incident also induced a so-called "Japanese premium" that heavily penalizes all

Japanese banks by inflicting on them a burdensome increase in interest rates. Why is such a penalty inflicted not just on Daiwa, but on all Japanese banks? Are there any precedents for such action?

Finally, Daiwa's stockholders recently brought a representative action against the Bank regarding this incident. Such an action has been imported from the United States and has not yet become popular in Japan. Stockholders' actions against corporations in Japan, and the meaning of such an action in this case bears review.

This case contains a broad range of complex issues, encompassing the government and business circles of both countries. Therefore, the method of analysis for these issues requires an extensive multi-disciplinary approach based on jurisprudential, economical, sociological, and international comparative studies.

This Article seeks to provide such a multi-disciplinary analysis. Part I of this Article reviews the factual background of the Daiwa Bank Scandal, explaining both the Bank's legal trading of U.S. Treasury bonds and the diversion of another $100 million in losses incurred by the Daiwa Bank Trust Company. Part II examines the legal actions taken against Daiwa Bank by the United States and suggests that such actions fall within the general trend of increased supervision by U.S. authorities over foreign banks. In Part III, this Article compares and contrasts the duty of disclosure under United States and Japanese law. Part IV of this Article discusses the reporting responsibilities of the MOF. Part V offers general improvements for the Japanese banking industry, concluding that both autonomous responsibility principles and free market doctrine are necessary to further Japanese banking in the international market. In Part VI, this Article discusses past suits and the subsequent standard of directors' liability and applies this standard to the Daiwa Bank suit. Part VII explains and reviews the Japanese premium. Finally, this Article concludes that further improvement of the relations between the United States and Japan requires a consensus regarding international business between them.

II. FACTUAL BACKGROUND OF THE DAIWA BANK SCANDAL

The Daiwa Bank scandal involves two major cases: (1) the illegal trading of U.S. Treasury bonds, which resulted in the loss of $1.1 billion, and (2) the "loss diversion" of about $100 million by Daiwa Bank Trust Company, a New York subsidiary of Daiwa Bank.

A. *Case 1: The Concealment of Daiwa Bank's Illegal Trading Losses*

Daiwa Bank[1] disclosed on September 26, 1995, that a Bank Vice-President, Toshihide Iguchi,[2] who was in charge of securities trading and control at its New York Branch, had been selling securities that the Bank had in its custody to cover up the loss created by his own unauthorized, unlisted trading of U.S. Treasury bonds. His trading had caused Iguchi's bank to lose a total of approximately $1.1 billion (approximately ¥110 billion). Iguchi's cover up consisted of the concealment of transaction confirmation statements and the forgery of securities balance certificates.[3] The amount of Daiwa's loss is among the highest in the history of similar cases.[4]

Although the loss in this case was caused by the criminal conduct of an individual, the multiple review of transactions, one of the basic rules for all financial institutions, did not work in this case. It is astonishing that this illegal trading remained undetected for eleven years.[5] Thus, it is important to see how it was concealed.[6]

When a bank trades U.S. Treasury bonds, securities companies—the bank's counterpart in the transactions—normally send transaction confirmation statements to the transaction control section of the bank. Iguchi, however, instructed the

1. Daiwa Bank is the 17th largest bank in the world with about $318 billion in assets and more than 9,000 employees. The corporation stock is listed in the Tokyo Stock Exchange. Established in 1918, its main office is located at 2-1, Bingo-Machi, 2-Chome, Chuo-ku, Osaka-shi, Osaka Japan. TOKYO KEIZAI, JAPAN COMPANY HANDBOOK 1100 (1996).

2. On September 26, 1995, the Federal Bureau of Investigations (FBI) arrested Toshihide Iguchi (age 44), a former employee of Daiwa Bank's New York Branch. *See Daiwa Bank's Huge Loss, 30,000 Unauthorized Transactions; FBI Announces Arrest of Daiwa Bank's Former Employee*, NIHON KEIZAI SHIMBUN, Sept. 27, 1995, at 1 (Japanese-language source).

3. For details of the concealment by Daiwa Bank, see Yoshiyuki Watanabe, *Daiwa Bank Conceals Wrongdoings*, BUNGEI SHUNJU, Dec. 1995, at 94-104 (Japanese-language source).

4. *See infra* Figure 1.

5. The incident became known to the management of the bank through Iguchi's confession letter dated July 24, 1995 and addressed to the president. For details of the confession letter, see *Exclusive Publication of Defendant Toshihide Iguchi's Confession*, BUNGEI SHUNJU, Jan. 1996, at 112-31 (Japanese-language source).

6. *See supra* note 3; *see also infra* Figure 2.

securities companies to send those statements directly to him. He also hid the true securities balance statements sent from custodial banks which held the traded Treasury bonds and delivered forged statements to the custodial control section of the Bank.

How could this happen? First, Iguchi was in charge of both securities trading and securities control. Second, he held these positions in the section that traded Treasury bonds for eleven years. It is quite unusual, even among Japanese banks, for an employee to remain essentially in one position for such a long period. Third, although it is customary for bank employees in the United States and Europe to take a long vacation once a year while another employee handles his or her job,[7] Iguchi never took any long vacations during the eleven-year period. Finally, with regard to market risk management, it is customary for Japanese banks to set up a trading limit for each trader. In this case, however, the Bank failed to detect the loss, which substantially exceeded the capacity of its New York Branch. While it is granted that the loss was covered up by unlisted or out-of-books transactions, the management's responsibility for the lack of more effective and stringent control is indisputable.

B. *Case 2: The Concealment of Daiwa Bank Trust Company's Losses*

In the course of investigating Iguchi's illegal trading losses, U.S. authorities found that the Bank had been hiding another huge loss. Daiwa Bank Trust Company (hereinafter Daiwa Bank Trust),[8] a New York trust company and subsidiary of Daiwa Bank, Ltd., had generated large losses that it had been concealing.[9]

Daiwa Bank Trust developed a latent loss of $31 million in 1984 as a result of its unlisted trading of U.S. Treasury bonds. In an effort to make up the loss, Daiwa Bank Trust continued to

7. *See supra* note 2, at 3.

8. Daiwa Bank Trust Company was established in New York in 1977 as a wholly-owned subsidiary of The Daiwa Bank, Ltd. With capital of $86,750,000, it has been operating mainly in the areas of corporate pension funds and petty loans of banking operations. The Bank will be closed as a result of the recent incidents. It currently employs 75 of which 66 are local employees. *Daiwa Bank Considering Reorganization; Plans to Integrate/Close U.S. Trust Subsidiary and Other U.S. and European Operations by End of This Month*, NIHON KEIZAI SHIMBUN, Oct. 13, 1995, at 7 (Japanese-language source).

9. *See infra* Figure 3; *see also Illegal Accounting Operations Using Two Subsidiaries to Hide U.S. Daiwa Bank Trust Company's Loss; Suspected of Profit Transfer*, NIHON KEIZAI SHIMBUN, Oct. 20, 1995, at 1 (Japanese-language source).

trade Treasury bonds; however, the loss continued to increase until it reached the staggering amount of $97 million at the end of September 1987. In 1986, Daiwa Bank, Ltd. established a paper company—Plaza International—in the Cayman Islands, a notorious tax haven, and the loss was transferred from Daiwa Bank Trust to this newly formed company.

The entire loss was subsequently transferred to another paper company, New Hope International, which was established in September 1987, also in the Cayman Islands. The technique used was for New Hope International to purchase Treasury bonds from Plaza International at the market price and then sell them back to Plaza International at the book value in order to cancel its loss. Under U.S. securities laws, this operation is considered an illegal transfer of profits or a diversion of loss.

In the meantime, a total of $40 million was invested from six companies, including Super Prime and PS America, both of which were paper companies created in the Cayman Islands by Daiwa Bank. Other subsidiaries, including Daiwa Overseas Finance (Hong Kong) and Daiwa Bank Trust, also provided loans to New Hope International. The total amount of loans provided by the Daiwa Bank group as a whole was $330 million.

All of these "cover-up" operations were done without any reports to the authorities of Japan and the United States. In addition, such actions raise a tax question of an illegal transfer of profits to overseas bases.

Moreover, there is a question of whether Daiwa Bank is to be held liable under *respondeat superior* for Iguchi's illegal transactions. While the prosecutor alleged that Daiwa Bank was liable under *respondeat superior* for the damages its customers and the U.S. financial authorities suffered due to illegal transactions, Daiwa Bank alleged that the case was a personal wrongdoing committed by the defendant Iguchi, and that, "the bank was a victim and was not responsible for the defendant Iguchi's misconduct."[10]

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10. *See Daiwa Bank Has Employer's Responsibility; Federal Prosecutor's Rebuttal Stresses Legitimacy of Accusation*, NIHON KEIZAI SHIMBUN, Feb. 13, 1996, at 3 (Japanese-language source). There is a difference between Japanese and U.S. laws regarding *respondeat superior*, causing a difference of opinion between U.S. authorities and Daiwa Bank in this case. According to common law principle operating in the United States, an employer is held liable for the conduct of its employee that results in damages to third parties during the course of his or her employment, regardless of whether or not the employer was at fault. According to Japanese law, an employer is liable only when the employer was negligent in the selection and supervision of the employee. However, Japanese law places more responsibility on the employer in its interpretation of an employee's course of

Figure 4 in this Article provides a chronological list of the events in Case 1 and Case 2. It is clear from this list that systematic concealment efforts were made for the last eleven years. Even so, the Bank asserts that it is not guilty, as a person or corporation, of any criminal offenses in both cases.[11]

As expected, however, Daiwa Bank recently agreed to a plea bargain with the prosecutor to settle the case by admitting some wrongdoing and paying a penalty.[12] It admitted wrongdoing as to sixteen of the allegations, most notably the intentional concealment and conspiracy regarding a loss, which were regarded as the center of the accusations. Daiwa paid $340 million (approximately 35.6 billion yen) in penalties.[13] As a result of this plea bargain, the case involving the Bank itself was settled.[14] However, since plea bargaining does not exist under Japanese law, there has been some strong criticism in Japanese economic circles of this mode of settlement by Daiwa Bank, arguing that the bank should have fought to the end to clarify its role in the matter.[15] How this bargaining will affect the stockholders' representative action in Japan will be closely watched.

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employment. MINPO (Civil Code), Law No. 89 of 1898 and Law No. 9 of 1898, art. 715 (Japanese-language source).

11. Faced with this fact, Daiwa Bank claims the following: (1) that its former New York Branch general manager is not guilty of misprision of felony, for which he has been arrested and indicted in Federal District Court of the Southern District of New York, and (2) that the allegations made against the Bank as a corporation of misprision of felony and obstruction of the examination of the financial institution by the authorities are inappropriate. *Former NY Branch Manager Claimed Not Guilty; Defendant's Lawyers of Daiwa Bank Case Claim Main Case Itself is Illegitimate as Well*, NIHON KEIZAI SHIMBUN, Nov. 22, 1995, at 4 (Japanese-language source).

12. For details of this plea bargain, see *Daiwa Bank Seeks Judicial Settlement, Admits Huge Loss and Conspiracy; Federal Prosecutor Charges $35.6 Billion Penalty for 16 Accounts Including Delayed Report; Affected by MOF's Intention*, NIHON KEIZAI SHIMBUN, Feb. 29, 1996, at 1 (Japanese-language source).

13. *Id.*

14. *Id.*

15. *Id.*

Fig. 1 Major Financial Losses of the World
(in the order of amount)

Main entity involved	Loss (¥billion)	Contents of trading	Discovered
Showa Shell Sekiyu (Japan)	165.3	Foreign exchange futures	Feb 1993
Kashima Oil (Japan)	152.5	Foreign exchange futures	Apr 1994
Orange County, CA (USA)	145.0	Derivatives	Dec 1994
Bearings (UK)	130.0	Stock futures	Feb 1995
Daiwa Bank (Japan)	110.0	U.S. Treasury bonds	Sep 1995
Tokyo Securities (Japan)	32.0	U.S. Treasury bonds & currency options	Nov 1994
Tateho Chemical Industries (Japan)	28.6	Securities futures	Sep 1987
Proctor & Gamble (USA)	15.2	Interest swap	Apr 1994
Nippon Steel Chemical (Japan)	13.9	Foreign exchange futures	Jul 1993
Nippon Sanso (Japan)	11.9	Interest swap	Mar 1995

Source: *Cause of Daiwa Bank's Huge Loss: Loose Risk Control*, NIHON KEIZAI SHIMBUN, Sept. 27, 1995, at 3

Fig. 2 Unlisted Trading of U.S. Treasury Bonds by Daiwa Bank

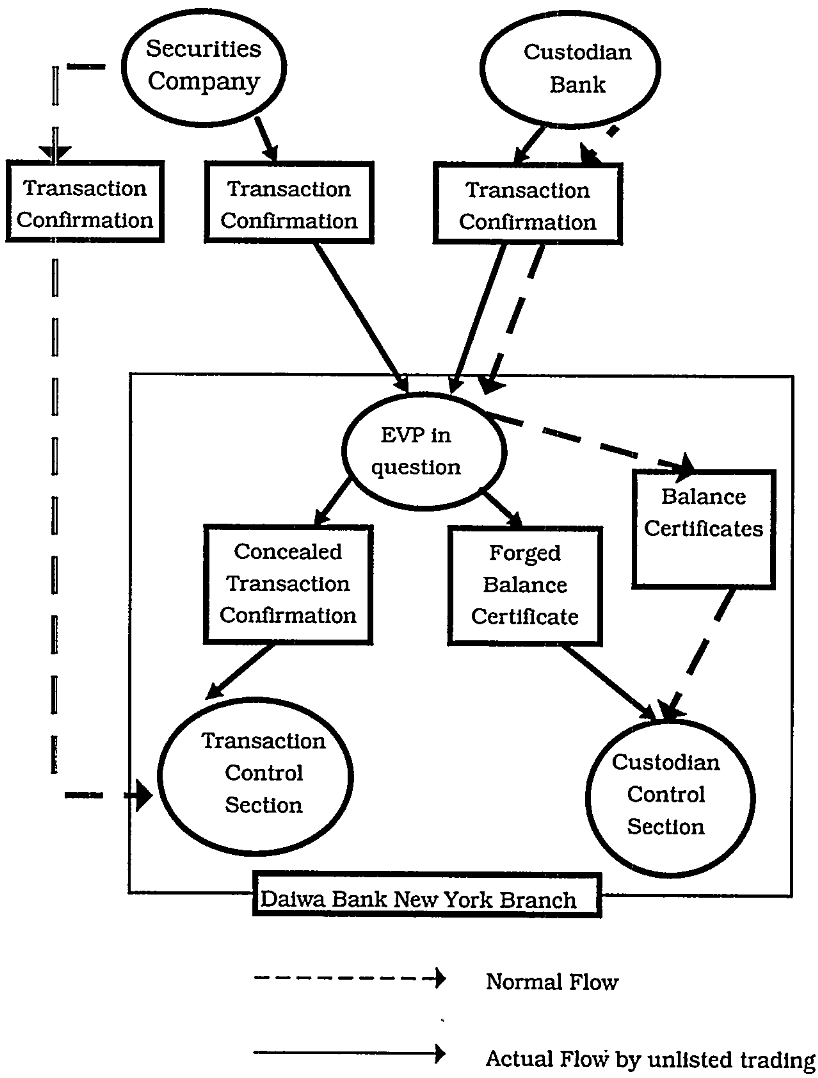
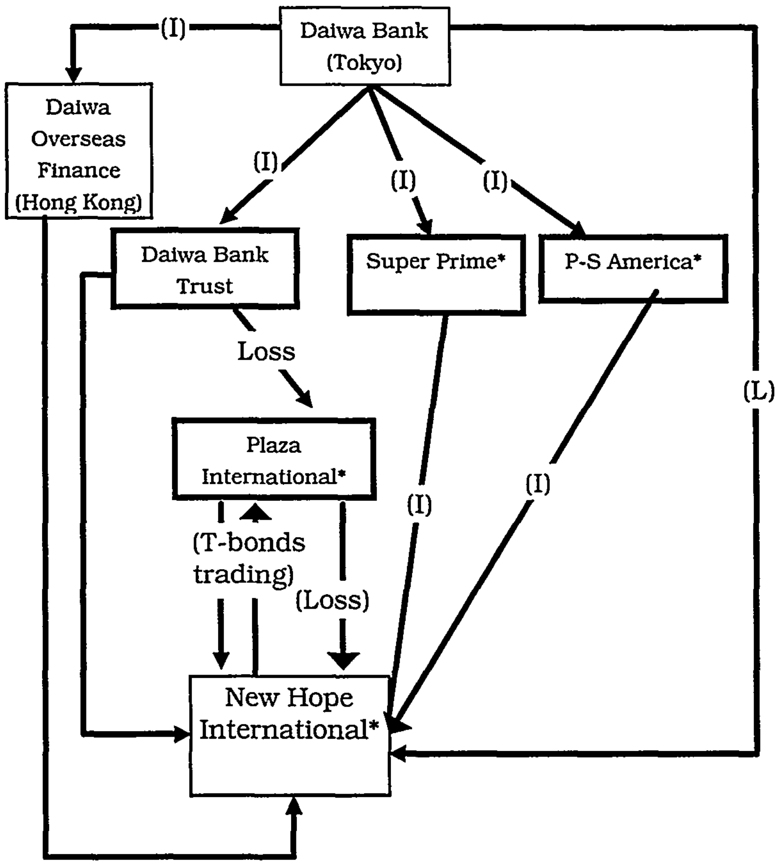


Fig. 3 Method of Hiding Losses Generated by Daiwa Bank Trust



Note: (1) All of these (asterisked) paper companies were established on the Cayman Islands.

(2) (L) denotes loan.

(I) denotes investment

Fig. 4 Chronological List of Events Leading to Enormous Losses at Daiwa Bank

Date	(Case 1)	(Case 2)
1984	Iguchi started unlisted (out of books) trading of Treasury bonds	Daiwa's U.S. subsidiary, Daiwa Bank Trust, developed losses in unlisted (out of books) trading of Treasury bonds
1992	Concealed the lack of separation between the Treasury bond trading and custodial operations during examination by New York FRB	
1993	Daiwa Bank submitted to New York FRB a false report based on concealment activities	
1994		Daiwa Bank completed the process using separate companies to cover up the loss created by its U.S. subsidiary.
July 24, 1995	Pres. Fujita received a confession letter from Iguchi	
July 28	Managing Dir. Yamaji sent to United States to investigate	
August 8	Fujita reported the existence of Iguchi's confession letter to Dir. Gen. Nishimura of Banking Bureau, MOF	

September 12	Daiwa Bank reported the outline of the incident to MOF	
September 14	Vice Pres. Yasui explained the incident to Vice Pres. Fukui of the Bank of Japan	
September 18	Daiwa Bank made an official report to Japanese and U.S. authorities	
September 26	Daiwa announced the above incident at a press conference	
October 6		Daiwa reported the loss of Daiwa Bank Trust to Japanese and U.S. authorities
October 9		Resignation of Pres. Fujita was announced at a press conference. The above-mentioned loss was also disclosed.

Source: *City Bank's Reorganization Issues Focusing on Daiwa Bank Case; Huge Loss Shakes Reorganization Base with Resurfacing Merger Rumors*, NIHON KEIZAI SHIMBUN, Oct. 10, 1995, at 8 (Japanese-language source).

III. U.S. ADMINISTRATIVE LEGAL ACTIONS AGAINST DAIWA BANK

On November 2, 1995, the FRB ordered Daiwa Bank to close its branches and terminate all operations in the United States within ninety days.[16] Moreover, for the next three years, Daiwa Bank is obligated to submit a petition in writing if either the Bank or its affiliates wish to reopen operations in the United States. This petition is then subject to the discretionary control of U.S. authorities.[17] In practical terms, this means that Daiwa Bank has been completely banished from the United States. This action by U.S. authorities is viewed as an "abnormally" severe punishment in Japan.[18] This Article next examines whether this Japanese claim has any merit by reviewing the legal grounds of the FRB's action and the judgment that undergirded it.

According to the International Banking Act (IBA),[19] there are two grounds on which FRB can base its decision of the deportation of Daiwa Bank. The first possible reason is that Daiwa Bank did not obey the supervision or regulation of the MOF.[20] Since Daiwa Bank had been consulting with the MOF, it

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16. Senjin Kishi, *Fault of MOF Which Betrayed World and Japan; Japan Financial Administration, Far Apart From Anglo-Saxon Logic*, ECONOMIST (Japan), Dec. 5, 1995, at 40-42.

17. *Id.*

18. *U.S. Intensifies Criticism Against MOF; MOF Should Not Discuss It's Role*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 22 (Japanese-language source).

19. 12 U.S.C. § 611 (1994).

20. *See* Sections 7(e) and 10(b) of the International Banking Act, added in 1991 as amendments:

> The Board may order a foreign bank to terminate the activities of such branch, agency, or subsidiary, if the Board finds that—
> (A) the foreign bank is not subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country; or
> (B)(i) there is reasonable cause to believe that such foreign bank, or any affiliate of such foreign bank, has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States; and
> as a result of such violation or practice, the continued operation of the foreign bank's branch, agency, or commercial lending company subsidiary in the United States would not be consistent with the public interest or with the purposes of this Act, the Bank Holding Company Act of 1956 or the Federal Deposit Insurance Act.

12 U.S.C. § 3107(b) (1994).

And, in case of termination of a Federal branch of agency:

> The Board may transmit to the Comptroller of the Currency a recommendation that the license of any Federal branch or Federal agency of a foreign bank be terminated in accordance with section 4(I) [12 U.S.C. § 3102(I)] if the Board has reasonable cause to believe that such foreign

is unlikely that this was the reason for the FRB's decision. We have to assume that the FRB's action was based on the second reason: Daiwa Bank's operations included those that can be considered unsafe and unsound banking practices.[21]

First, Daiwa Bank violated the law that imposes certain reporting obligations. Daiwa Bank failed to file a criminal referral report within thirty days after the date of detection, the period defined in Regulation H,[22] in both Case 1 and Case 2.[23] It seems inconceivable, however, that the FRB decided to expel Daiwa Bank permanently from the U.S. solely on the ground that the Bank violated this reporting rule. The punishment for a violation of the reporting duty alone should entail, at most, a fine imposed on the Bank or a criminal penalty against the individual(s) involved.[24]

> bank or any affiliate of such foreign bank has engaged in conduct for which the activities of any State branch or agency may be terminated.

12 U.S.C. § 3105(e)(5) (1994).

21. *Id.*

22. FRB Rule on Reports of Crimes and Suspected Crimes, 12 C.F.R. § 208.20 (1996).

23. 12 C.F.R. § 208.20 (1996) provides:

> A state member bank shall file a criminal referral report . . . in every situation where the State member bank suspects one of its directors, officers, employees, agents, or other institution-affiliated parties of having committed or aided in the commission of a crime. . . . A state member bank shall file the report . . . no later than 30 calendar days after the date of detection of the loss or the known or suspected criminal violation or activity. If no suspect has been identified within 30 calendar days after the date of the detection of the loss or the known, attempted or suspected criminal violation or activity, reporting may be delayed an additional 30 calendar days or until a suspect has been identified; but in no case shall reporting of known or suspected crimes be delayed more than 60 calendar days after the date of the detection of the loss or the known, attempted or suspected criminal violation or activity. When a report requirement is triggered by the identification of a suspect or group of suspects, the reporting period commences with the identification of each suspect or group of suspects.

24. Any foreign bank, or any office or subsidiary of a foreign bank, that—

> (A) fails to make, submit, or publish such reports or information as may be required under this Act or under regulations prescribed by the Board or the Comptroller of the Currency pursuant to this Act, within the time period specified by such agency; or
> (B) submits or publishes any false or misleading report or information, . . .
> shall be subject to a penalty of not more than $20,000 for each day during which such failure continues or such false or misleading information is not corrected.

In addition to the reporting rule violation mentioned above, Daiwa Bank committed two additional violations.[25] In Case 1, the Bank had been making false reports to the authorities for the past eleven years in order to conceal the unlawful trading. In addition, it also tried to hide the facts of this situation after management received Iguchi's confession.[26] In Case 2, the Bank conducted a systematic concealment operation regarding the loss generated by Daiwa Bank Trust. It is assumed that when the FRB discovered these two violations, in addition to the reporting rule violation, it concluded that the Bank had been conducting an "unsafe and unsound banking practice."[27]

In the background of the FRB's decision is the Bank of Credit and Commerce International (BCCI) case.[28] BCCI was notorious for its underground activities, such as drug money laundering, and was called "the world's dirtiest bank." In 1991, British

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12 U.S.C. § 3110(c) (1994):

> Whoever, with the intent to deceive, to gain financially, or to cause financial gain or loss to any person, knowingly violates any provision of this Act or any regulation or order issued by the appropriate Federal banking agency under this Act shall be imprisoned not more than 5 years or fined not more than $1,000,000 for each day during which a violation continues, or both.

25. Per the complaint of the U.S. prosecution authorities. *See Former N.Y. Branch Manager claimed Not Guilty; Defendant's Lawyers of Daiwa Bank Case Claim Main Case Itself is Illegitimate as Well*, NIHON KEIZAI SHIMBUN, Nov. 22, 1995, at 4 (Japanese-language source).

26. *Id.*

27. *Id.*

28. The BCCI (Bank of Credit and Commerce International) group is a multinational group of financial institutions having 365 offices in 69 countries around the world and was one of the largest Arabian financial institutions. The BCCI group was established by a Pakistani businessman in 1972 and the largest group of stockholders consist of the Emirate of Abu Dhabi and the people related to its government. BCCI Holding, the holding company of the BCCI group, has a token head office in Luxembourg for the purpose of registration and the actual head office in London.

The BCCI group had been suspected of drug money laundering for some time. When its performance deteriorated due to failures of loans without collateral as well as dealing failures, it covered up its settlements with window dressing.

On July 5, 1991, having been convinced of BCCI's long term window dressing settlement practices, Bank of England, in coordination with the financial authorities of the United States (where First American Bank, its subsidiary in a practical sense, exists), ordered BCCI to halt its operations and froze its assets in each country in order to prevent its customers' run on the bank and the insiders from hiding its assets.

For details of the history of the BCCI Group and the BCCI case, see *BCCI Case's Full Picture; Other Countries' Responses and Developments in Japan*, KINYU HOHMU JIJYOU (Financial and Legal Affairs), Nov. 25, 1991, at. 4-12 (Japanese-language source).

authorities ordered BCCI to stop its operations, which practically forced BCCI into bankruptcy. In the United States, authorities found that BCCI was illegally lending to one of the nation's largest banks, Washington, D.C.-based First American Bank. As a result, the United States fined BCCI $200 million and permanently expelled from U.S. banking nine people who were involved in the case.[29]

In contrast to the industry case of Daiwa Bank, however, no expulsion actions were taken against BCCI itself by U.S. authorities. BCCI, however, stopped its operations on its own initiative and retreated from the United States. From the FRB's standpoint, the most serious violation by BCCI was the false report it made to U.S. authorities when it bought First American Bank. As a result of this incident, a revision of the IBA was introduced in 1991 to enhance the FRB's authority substantially, giving it powers such as that of canceling licenses and examining all foreign bank branches in the United States.[30]

The order to terminate operations that was given to Daiwa Bank is the first action of its kind taken by the FRB since the revision of the IBA in 1991. While some people think that this action is too severe, it is neither unusual nor unduly harsh if one understands the trend towards increased supervision by U.S. authorities over foreign banks.

IV. DISCLOSURE REQUIREMENTS AND DUTIES OF BANKS AND DIRECTORS: UNITED STATES V. JAPAN

Although they knew about the huge losses described above, the management of Daiwa Bank delayed disclosure of that information to the FRB for a substantial period. The FRB thought that this delay was a serious violation of the reporting rule under the IBA. In addition, Daiwa Bank may have been required to disclose this important information, which is logically expected to influence the securities market, to stockholders as well as to the general public, which includes stockholders. While this is not the direct concern of the FRB, if the management of Daiwa Bank felt it had a responsibility towards stockholders to disclose, it should have reported such information to United States and Japanese authorities at the appropriate time. From this standpoint, whether the Bank and its directors were obligated to disclose such information to the stockholders is deeply related to the

29. See KINYU HOHMU JIJYO (Financial and Legal Affairs), *supra* note 28.
30. *See supra* note 20.

reporting duty to the FRB. Furthermore, the Bank and its directors may have been responsible for the disclosure of important information under the Securities and Exchange Law of Japan, as Daiwa Bank's stock was traded on Japan's stock market.[31]

What is notable here is that Daiwa Bank asked a third party to purchase its stock without disclosing the concealed losses, thus causing damage to this third party. Asahi Mutual Life Insurance Co. (Asahi Seimei), a major life insurance company in Japan,[32] bought a large sum of Daiwa Bank's stock shortly before the incident was disclosed.[33] Asahi Seimei commented later that "the stock purchase was made on the request of Daiwa, and it is regretful that the loss disclosure was not made."[34]

The facts of this case reveal that a "director of Daiwa Bank urged Asahi Seimei to buy Daiwa Bank's stock from the open market without disclosing an important piece of information regarding Daiwa Bank that might affect the market negatively."[35] Asahi Seimei already owned 2.7 million shares of Daiwa Bank stock at that point.[36] Asahi Seimei decided, however, that additional shares would be helpful to enhance its business in the Kansai District, where Daiwa Bank had its head office, and thus, bought a total of 5 million shares in six installments between late August, and late September, 1995, immediately before the disclosure of this incident.[37] During this period, Daiwa Bank shares traded at slightly over 800 yen per share; the price subsequently dropped to about 600 yen per share, causing the

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31. If Daiwa Bank's stocks were traded on the U.S. market, or if Daiwa Bank had been issuing its securities in the United States, so that there were stockholders in the United States, then the U.S. Securities Acts would have been applied. However, that was not the case.

32. The fifth largest life insurance company in Japan. 1995 revenue: 1,960 billion yen. Head office: 1-7-3 Nishi-Shinjuku, Shinjuku-ku, Tokyo. TOYO KEIZAI, KAISHA SHIKI HO (Corporate Quarterly Report) 1591 (1996) (Japanese-language source).

33. *Daiwa Bank's Huge Loss Case, Disclosure Tardiness Undeniable; Finding of Preferred Stock Issuance After Former Bank Employee's Confession Causes Distrust in Domestic and Overseas Markets*, NIHON KEIZAI SHIMBUN, Nov. 29, 1995, at 3 (Japanese-language source).

34. *Id.* Although a company is allowed to own its own stocks in the form of Treasury Stocks in the United States, it is forbidden to do so in Japan. SHOHE (Commercial Code), Law No. 48 of 1899, art. 210. Therefore, when a company wants to ask the third party to obtain the company's stocks or increase the number of its stocks the third party owns, it is a common practice in Japan to ask the third party to purchase the company's stocks through the stock market.

35. *Id.*

36. *Id.*

37. *Id.*

insurance company to incur an unrealized loss of ¥650 million (about $6.5 million).[38]

The next question to be examined is whether Daiwa Bank had a duty to disclose this important information to stockholders, including Asahi Seimei, according to the Securities and Exchange Law of Japan. When a director discloses an important piece of information about the company, he or she may either disclose it or make the company disclose it. In either case, the director must always choose between the following duties: (1) the duty owed to the stockholders to disclose the information as soon as possible; and (2) the duty owed to the company not to disclose any information without first investigating thoroughly the accuracy of the information. In some cases, this choice can be an extremely difficult one. While the director did not sell the stock he himself owned to Asahi Seimei, Asahi Seimei would not have purchased Daiwa Bank's stock if it had known of the negative information. Therefore, as far as the director's duty of disclosure is concerned, it is reasonable to assume that the case is similar to the director's selling of his own stock to another stockholder without disclosing the negative information. The Asahi Seimei Case illustrates the difference in director's duties under United States and Japanese law.

The disclosure duty under the common law in United States is as follows: For liability to occur, (1) a party involved in a business transaction must intentionally prevent another party from obtaining an important piece of information by concealment or otherwise,[39] or (2) a party must owe to another party a duty "to exercise reasonable care to disclose matters known to him that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[40] Otherwise, it cannot be sued for fraud based on its failure to disclose information. As to the fiduciary, however, the party has not only an "affirmative duty of utmost good faith, and full and fair disclosure of all material facts," but also an affirmative duty to 'employ reasonable care to avoid misleading' his clients."[41]

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38. *Id.*

39. RESTATEMENT (SECOND) OF TORTS § 550 (1976).

40. *Id.* § 551 (2)(a).

41. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963). In equity law, fraud includes all actions, omissions and concealment that cause damages to other people, with violations of duties, trusts or confidence duly placed under the common law or the equity law, or all actions, omissions or concealment to deprive other people inappropriately and unconscientiously of opportunities to make profits. *Id.*

Under U.S. case law, it has been discussed extensively whether a fiduciary relationship exists between a director and a stockholder. It is clear under U.S. case law that such a fiduciary relationship does exist between a director and a company when a director buys the company's stock from a stockholder and takes advantage of knowledge of internal information of the company. Similarly, there exists the question of whether or not Daiwa Bank had a disclosure duty with regard to Asahi Seimei, a stockholder, in urging Asahi Seimei to buy shares from the market.

The "majority" rule is that, "officers and directors do not have active liabilities for disclosure responsibilities unless misstatement, unclear representation, or intentional concealment were made either verbally or by actions. However, since they have fiduciary obligations to the company and the stockholders with regard to trading with the company and for the company, they have the disclosure duties."[42] According to this rule, it is fair to conclude that the directors of Daiwa Bank had a disclosure duty in the Asahi Seimei case.

The "minority" rule states that "the insider (officers, directors, and major shareholders owning more than 10% of the stocks) of a company is construed to have a fiduciary relation with a stockholder in a stock trading so that the former has to make a complete disclosure on all important matters."[43] Based on this standpoint, there is no question that a disclosure duty exists for those Daiwa Bank directors in the Asahi Seimei case.[44]

Against this backdrop of U.S. common law, the securities laws[45] contain several prohibitive rules against fraudulent

42. The leading case for this view is Carpenter v. Danforth, 52 Barb. 581 (N.Y. Sup. Ct. 1868).

43. Oliver v. Oliver, 45 S.E. 232, 234-35 (1903); Stewart v. Harris, 77 P. 277, 279 (1904); Jacobson v. Yaschik, 155 S.E.2d 601, 605-06 (1967).

44. A third theory on this matter is an intermediate position in that it states that an insider owes a responsibility for non-disclosure in special circumstances. Even from this standpoint, the disclosure duty of Daiwa Bank is undeniable. For the third theory, see Strong v. Repide, 213 U.S. 419, 431 (1909). The court held that the purchase of stocks from minor stockholders by a dominant stockholder and administrative general without disclosing the pending sale of a company asset, constituted an unlawful fraud. Its decision was based on its finding that it was the defendants' duties to act honestly and disclose the facts prior to said purchase, *given the defendants' positions as insiders and the special knowledge they had. Id.*

45. United States Securities Act of 1933, 15 U.S.C. §§ 77a-78mm (1934) and The Securities Exchange Act of 1934, 15 U.S.C. §§ 77a-78jj (1934).
The Act of 1933 was intended to achieve "truth in securities" related to the public offerings in the issuing market, while the Act of 1934 intends mainly to control activities of brokers and dealers as well as the securities market where they

activities;[46] in particular, they deem illegal an "insider's" use of insider information in trading securities. Specifically, Section 10(b) of the Securities Exchange Act of 1934 obligates certain insiders, namely officers, directors, and major stockholders, to pay the company any profit they earned on account of insider information within the past six months. Whether such an action is to be construed as "insider trading" is judged according to Rule 10b-5, a derivative rule of Section 10(b).

It is difficult to believe that the insiders of Daiwa Bank did not trade Daiwa Bank's stock at all while important information was being withheld. If there were any such trading, Rule 10b-5 should be applied. The directors of Daiwa Bank must have had the choice "either to disclose the important information or to abstain from trading."[47] It must have been the same in the case of asking Asahi Seimei to buy Daiwa Bank's stock from the market. The particular director of Daiwa Bank must have had the choice "either to disclose or not to ask for such a trade."

In the United States, the disclosure duty according to Rule 10b-5 is not limited to the case of a direct deal between an insider and a stockholder, but rather it imposes a wider duty on insiders to urge the company to disclose fully any important information that might influence the evaluation of the stock of the company on the stock market. It seems that, although the responsibility of disclosure by the company is stressed, the company's response is generally slow and limited by its pursuit of its own interest. Thus, the responsibility of disclosing to the general public seems to fall on the insiders themselves.

There is no question that insiders will be charged with violations of 10b-5 for distributing false information through reports, newspaper releases, comments by directors, or any other methods, even if they were not involved in any trading.[48] The

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operate; at the same time, it established a disclosure system (Securities Report System) that obligates them to disclose pertinent information continuously.

46. The most important ones are Section 17(a) of Securities Act of 1933 and Sections 9(a)(4) and 10(b) of Securities Exchange Act of 1934. These rules determine that "the use of market maneuvering or fraudulent device or contrivance related to the issuing, buying or selling securities is illegal."

47. *See supra* note 33.

48. In the *Texas Gulf Sulphur* case, where the focus of the lawsuit was a misleading newspaper report describing a large mineral deposit found in Canada as uncompromising, the Second Circuit Court stated in its final judgment that it seems that it is not unfair to hold the management of a company to be responsible to confirm the accuracy of any announcements the company makes to stockholders or the general public. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-62 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC and Kline v. SEC, 394 U.S. 976 (1969). In other words, the court delivered a judgment that rule

question, however, is whether or not they will be convicted of violating Rule 10b-5 when they fail to announce an important piece of information that most likely would have affected the market price. There is no Supreme Court case that deals with this particular issue. Both the SEC[49] and the U.S. courts[50] consider it appropriate to temporarily withhold an important piece of information from the market if there is a sufficient business reason to do so. During the period the information is withheld, neither the issuer nor insiders may conduct trading. If this concept is applied to the Asahi Seimei case, Daiwa Bank's (or its directors') request that the third party purchase the Bank's stock is equivalent to doing the trading by itself, and thus, a court is likely to find that it is not possible to conduct such trading legally while withholding such information for a substantial period of time.

Accordingly, leading stock exchanges in the United States request listed companies to "quickly disclose any news or information that is reasonably expected to provide a serious effect on the securities market," and to "take actions to deny quickly any groundless rumors that otherwise might cause abnormal market reactions or price fluctuations."[51]

Taking these rules and regulations in the United States as the premise, the Asahi Seimei case, in which a director of Daiwa Bank asked and actually made the third party buy the Bank's shares, though acquired in the stock market, can be considered a violation of the law because of its similarity to the case where an insider would be involved in the transaction itself. In this case, the insider was obligated to disclose the important information known to him because of his position, but unknown to the other party, which would have affected the other party's investment judgment. In such a case, a clash is inevitable between the Rule 10b-5 duty of a director to disclose important information as soon as possible and the duty of a director under the common law not to disclose information prematurely. If disclosure prior to the buying or selling is inappropriate or unrealistic, then the only

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10b-5 is always considered to be violated in a case such as follows: when an announcement was made in a rationally calculated method in order to influence the investing public, e.g., by media reporting financial status, and said announcement was fraudulent or likely to cause misunderstanding or, so imperfect as to cause misunderstanding, irrespective of whether the announcement was motivated by a secret purpose of the officers of the company or not. *Id.* at 862.

49. Investors Management Co., Inc., 44 S.E.C. 633, 646 (1971).

50. Dolgow v. Anderson, 438 F.2d 825, 829 (2d Cir. 1971).

51. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL 202.

choice left is to give up trading. Moreover, if it is proved that the director not only failed to disclose such important information, but also intentionally concealed it, there is a possibility that he would be accused of violating both the general fraud prohibition provision, Section 9(a)(4), which prohibits market manipulation, and Rule 10b-5.

The present case, however, appears entirely different under Japanese law. It is difficult under Japanese law to establish a complaint against Daiwa Bank and its directors as to the non-disclosure of the important information. Although disclosing fraudulent information is an offense under Japanese law as well, failure to disclose information that would affect the stock price is not an offense.

Based on the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934, the Securities and Exchange Law[52] of Japan contains a detailed rule on disclosures by corporations. The Securities and Exchange Law of Japan is intended to protect past and future investors in corporations by focusing on the disclosure system. While rules of investor protection existed in the Commercial Code, they did not sufficiently cover the disclosure of corporate accounting.[53] Therefore, the Securities and Exchange Law was introduced as a supplement to secure smooth and fair trading of securities as well as to protect investors.

52. SHÔKEN TORIHIKI HÔ [Securities and Exchange Law], Law No. 25 of 1948, *translated in* 3 INT'L SEC. REG. Japan Booklet 2, at 14 (1992) [hereinafter Securities and Exchange Law]. Subsequent amendments to this law reflected developments in the United States. The occupation authorities enacted the Securities and Exchange Law at the end of the Second World War as a condition for the reopening of the securities exchange market in Japan.

53. ShoHô [Commercial Code], Law No. 48 of 1899, was modeled after German laws, while the Securities and Exchange Law was copied from the U.S. laws after W.W.II. Germany is a civil law country, while the United States is a country of the common law. Any confusion in the concept of disclosure in Japan may be attributed to the slight difference in the disclosure rules of the two source countries. For an examination of the development of the Japanese securities market, see Mitsuru Misawa, *Securities Regulation in Japan*, 6 VAND. J. TRANSNAT'L L. 447 (1973). Further, as to the internationalization of the Tokyo Stock Market, see Mitsuru Misawa, *Tokyo as an International Capital Market—Its Economic and Legal Aspects*, 8 VAND. J. TRANSNAT'L L. 1 (1974). It is safe to say that, when the loyalty of employees to the company is compared to their loyalty to the stockholders, the latter is given priority in the United States, while in Japan, the former is given priority. The loyalty to the company not to disclose prematurely is a part of the traditional social system in Japan and the lifetime employment system goes hand-in-hand with this loyalty. This loyalty given by directors and employees to the company is one of the basic principles of the Commercial Code of Japan.

The Japanese law also prohibits insider trading,[54] as does Rule 10b-5 of the U.S. Securities Exchange Act of 1934. However, if an insider owns the stock of his own company under the name of a third party or a fictitious person, voluntary reporting will probably be meaningless. In addition to the fact that it is practically impossible to detect the violation, the stipulation that the director who benefited from the insider trading must return the resulting profit to the company makes it difficult to expect any significant effects, given the social custom of Japan, unless there is an internal power struggle within management. Consequently, it is very seldom that this Japanese insider trading rule is activated; it is considered essentially a dead letter, when compared with U.S. law.

As a result, the question of whether or not a director of a company has a duty to inform the other party about inside information when trading his or her company's stocks has been met generally with a negative answer. In fact, except in a clear case of fraud, the contract will not be negated. A director will not be obliged to indemnify the other party just because the director failed to disclose a piece of inside information about the company that the director came to know in the course of his or her work, unless the other party asked the director to disclose such information. Moreover, a director will not be held legally accountable for his or her company's nonfeasance in failing to disclose important information, even if it was information that could be reasonably expected to have a substantial influence on the securities market according to this rule.[55] Therefore, it is impossible to label the responsibility of any particular director for non-disclosure of the information in the Asahi Seimei case as a violation of Section 189 of the Securities and Exchange Law of Japan, which corresponds to Rule 10b-5 of the U.S. Securities Exchange Act of 1934.

Even in Japan, however, the situation would be different if a person is actively involved in concealing information, in addition

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54. Securities and Exchange Law, *supra* note 52, at 189.

55. The disclosure of important information based on the request of the stock exchange also is not uncommon in Japan as a follow-up procedure of information already announced. After the incident was disclosed, the possibility of merger between Daiwa Bank and Sumitomo Bank was rumored. In response to this, the Tokyo Stock Exchange requested both banks to disclose information in writing, but both banks responded by saying that "there is no specific merger plan." *Chairman of Tokyo Stock Exchange Asks for Disclosure if any Changes Exist in Sumitoma Bank and Daiwa Bank Merger*, NIHON KEIZAI SHIMBUN, Nov. 22, 1995, at 4 (Japanese-language source). The Tokyo Stock Exchange further asked both banks to "disclose information as quickly as possible if any changes occur, since the merger is expected to affect the stock prices." *Id.*

to delaying its disclosure. Although it is difficult to seek punishment based on violation of the Insider Trading Prohibition (Article 189 of the Securities and Exchange Law of Japan), as those cases in the United States[56] are not established in Japan, such action can probably be prosecuted as an illegal transaction that violates the general fraud rule.[57]

In essence, one must conclude that it is difficult to hold a director in Japan legally accountable in these cases, unless the failure to disclose important information is accompanied with some fraudulent action such as concealment. While numerous investors, in addition to Asahi Seimei, must have bought Daiwa Bank's stock prior to the disclosure of the incident and incurred damage due to the price drop of the stocks,[58] there is no legal remedy based on the Securities and Exchange Law of Japan.[59] The only way to obtain a remedy is to bring a derivative suit under the Commercial Code,[60] charging a violation of the duty of

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56. *See supra* notes 49-50.

57. The Securities and Exchange Law of Japan also prohibits fraudulent operations with Article 58 against illegal trading which corresponds to Article 17(a) of U.S. Securities Act of 1933 and against manipulation of the stock market with Article 125 which corresponds to Article 9 of U.S. Securities Exchange Act of 1934. The difference between Article 58 and Article 125 is that Article 58 is a comprehensive prohibition rule to prohibit all fraudulent actions in general while Article 125 is intended to secure a free and open market. Due to the nature of these two rules, it often happens that a case violates Article 125 and Article 58 at the same time.

58. Although MOF did not comment on the case of Asahi Seimei's purchase of the stocks, it commented on the issuing of preferred stocks in Japan by Daiwa Bank immediately before the incident was disclosed, saying that, "there is no specific procedural problem in regard to the Securities and Exchange Law." *No Procedural Fault in Issuing Preferred Stocks After Confession of Former Employees, MOF's Vice Minister Asserts*, NIHON KEIZAI SHIMBUN, Oct. 6, 1995, at 7 (Japanese-language source).

59. Daiwa Bank will install an internal proposal organization to promote the disclosure of the management information by the end of 1995 as the result of the experience. This is received as a progressive effort. In order to prevent any recurrence of such an incident and to improve the transparency of the management, an organization called "Action Direction Committee," a permanent proposition organization consisting of outsiders, will be started. The committee members include owner/operators of other companies, scholars and professionals, journalist, and general saving customers, totaling about 10 people. The committee will discuss and propose, in addition to the issues of how information disclosure should be handled, improvements of services to general saving customers and corporate customers, and more informative communications to the stockholders. *Mechanism for Management Information Disclosure Suggestions to be Installed in Daiwa Bank by Year End*, NIHON KEIZAI SHIMBUN, Oct 13, 1995, at 7 (Japanese-language source).

60. *See supra* note 53.

loyalty of the directors to the company. This method, however, is currently not very effective in Japan.

As we have seen so far, there is a marked difference between the United States and Japan regarding strictness in the pursuit of disclosure duties of corporations. It is safe to say that an average Japanese company has not felt a need to immediately disclose important information, until now. As a lesson from the Daiwa Bank case, it is important for Japanese banks to observe the disclosure principle more stringently and to disclose pertinent operating information to stakeholders, such as stockholders and corporate customers, earlier, more quickly, more frequently, and more thoroughly, rather than reporting it privately to authorities such as the MOF. The more thoroughly Japanese banks conduct disclosure, the higher their market evaluations will be. By assuming full and strict responsibility of management and supervision, they will be able to regain the trust of the international securities market.[61]

V. IN PURSUIT OF THE MOF'S REPORTING RESPONSIBILITY

Aside from focusing on the attempts by Daiwa Bank to hide losses, U.S. criticism has also targeted the closed-room administrative practices of the MOF itself. Such criticism arises from the MOF's failure to notify U.S. financial authorities for six weeks after the MOF received its report from Daiwa Bank.[62] Sharp criticisms against the MOF are surfacing in the United States one after the other, declaring that it was the MOF that was really at fault in the matter rather than Daiwa Bank, since it

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61. The necessity for disclosure by Japanese banks is desired by a wide range of international observers. For example, Kevin Mellyrin, a consultant, and Arthur M. Mitchell, a lawyer, claimed that "[i]f Japan wants to develop world-class financial institutions that are necessary to secure its position in the world economy, it is necessary for Japan to ask for a more thorough and consistent disclosure practice from its banks." *Self-Renovation of Japanese Banks Desired Urgently*, NIHON KEIZAI SHIMBUN, Dec. 4, 1995, at 23 (Japanese-language source).

62. It was August 8, 1995 when the president, an executive vice president in charge of international operations and a managing director of Daiwa Bank met with the Director General of the Banking Bureau of MOF at the bank's club to report an illegal incident. In response, the Director General of the Banking Bureau told the representatives of the bank that "it [was] bad timing[,]" as disclosure might trigger instability in financial circles, and kept the secret in his pocket. It waited more than 40 days until September 18, 1995 when MOF finally notified the U.S. authorities. *MOF's Confusion at its Peak; Distrust of Japan's Financial Administration Heightens Regarding Daiwa Bank Scandal; Disbanding of MOF is Suggested*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 16 (Japanese-language source).

failed to follow necessary procedures after receiving the report from the Bank.[63]

As mentioned before, Daiwa Bank was "obligated to report to the FRB within 30 days after the criminal case was suspected," according to the Regulation H.[64] While the MOF's reporting duty does not stem directly from this law, it should have advised Daiwa Bank to report to the FRB.[65] The MOF is accused of being morally responsible for this nonfeasance. Moreover, even though there is no legal regulation to abide by, it is fair to say that, based on what this law stood for, the MOF had a responsibility to report this kind of information quickly to the FRB.

As to this implicit responsibility for the nonfeasance of the MOF, there is a strong view among the informed sources in the Japanese financial world that the MOF did not know about this thirty-day disclosure duty under the U.S. IBA.[66] However, the FRB and U.S. prosecutors do not think that this is true.[67] This reporting requirement was created only four years ago based on the experience of the BCCI affair, which shook the world.[68] Thus, it is difficult for them to believe that the MOF and Daiwa Bank, which had been operating in the United States for many years, did not know of it. Even if the MOF and the Bank did not know about the law, it is well-known of the jurisprudence in Japan, as well as that of the United States, that lack of knowledge of the law does not disprove the existence of intent or mens rea.[69] Since the

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63. As an example, a Wall Street Journal article stated:

> [T]he real rogue is Japan's [MOF]. In the Daiwa affair and in its handling of Japan's banking crisis, the [MOF] has shown its remarkable overconfidence and its willingness to bamboozle U.S. bank regulators, the Japanese public and even itself. . . . So maybe it wasn't surprising that the [MOF] thought it could flout U.S. banking regulations this summer by failing to report—for six weeks—what it had learned about Daiwa's illegal trades in the U.S. The trades cost Daiwa $1.1 billion. But they cost the [MOF] its reputation.

John Bussey, *Japan's Bungling Ministry of Finance*, WALL ST. J., Nov. 10, 1995, at A14.

64. *See supra* note 22.

65. *Suggestion for Disbanding of MOF Surfaced Abruptly with Daiwa Bank Scandal*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 12 (Japanese-language source).

66. *Id.*

67. *Id.*

68. *Id.*

69. "Ignorance of the law excuses no one (Ignorantia legis neminem excusat)" is one of the basic principles of the common law in the United States. In other words, everyone must know the ordinary laws of the country one lives in, and ignorance thereof does not excuse oneself from being charged with either civil or criminal liability. The same principle applies to the citizens of Japan. *See*

FRB's opinion is that the "MOF neither disclosed important information nor honored the reporting duty between the bank supervising authorities of the two countries" and that "[t]his is a breach of faith,"[70] the expulsion of Daiwa Bank should be understood as an indirect warning on the part of the FRB to the MOF.

The characteristics of the response of the MOF to the Daiwa Bank incident can best be described as obfuscation and delay, which is the traditional technique of the MOF based on their governing principle: "Never let them know; let them rely on us." "Obfuscation" and "delay" as well as "secrecy" are the key words often used these days in criticizing the Japanese financial system. They are analogous to "equivocation" and are taken as a kind of cover-up. All of these words suggest not an attitude of clarifying the problem and solving it, but of attempting to make the status and magnitude of the problem fuzzier, which is a typical form of "responsibility evasion."[71]

This secrecy-prone administrative technique by the MOF has severely damaged the international credibility of Japan.[72] Nevertheless, the MOF insists that this problem was created by

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KEIHO [Criminal Code], Law No. 45 of 1906, art. 38-3 [hereinafter Criminal Code] (Japanese-language source).

70. In the Senate Banking Committee's hearing on the Daiwa Bank incident, Mr. Alan Greenspan, Chairman of the Federal Reserve Board (FRB), said about MOF's delay in reporting to the U.S. authorities that "it is regretful that MOF made this error," while Chairman of the Banking Committee, Senator D'Amato, criticized MOF saying "MOF, which prevented the speedy report to the U.S. authorities in a collusion with Daiwa, severely damaged the trust between the two governments." *MOF's Failures are Regrettable*, NIHON KEIZAI SHIMBUN, Nov. 29, 1995, at 2 (Japanese-language source).

71. Another example that is causing criticisms against MOF from this perspective is the "Jusen" problem. Although MOF claims that the interest-free preferential credits of Japanese banks against Specialized Housing Finance Companies (Jusen) is ¥40 trillion, the actual figure is rumored to be ¥70 trillion. The U.S. authorities are irritated that MOF is not disclosing information in a straightforward manner and have the impression that MOF is engaged in a cover up, as in the Daiwa Bank case. *See Nippon Island of Bad Debts*, SHUKAN TOYO KEIZAI, Feb. 24, 1996, at 12-17 (Japanese-language source).

72. MOF has tried rebutting the criticisms regarding the delayed report on various occasions. While MOF is trying to convince the world by saying "there is nothing to be concerned about in the financial system," it has taken actions which indicate that it is deeply concerned by the loss of it credibility. For example, after the announcement of the affair, MOF showed keen interests in how it was perceived by overseas observers as exemplified by the Deputy Vice-Minister holding an explanatory meeting in Washington D.C., and the special press conference held by General Directors of Banking Business and International Finance Bureau with foreign correspondents in Tokyo. *See Outlandishness of Japanese Financial System Revealed; MOF Agonizes as its Rebuttals are Ignored*, NIHON KEIZAI SHIMBUN, Oct. 18, 1995, at 3 (Japanese-language source).

the "difference of culture between Japan and the [United States]."[73] and does not accept its fault, which is really the crux of the problem.[74] Such denial is similar to the fact that the management of Daiwa Bank did not realize its duty to disclose the important information at the earliest opportunity.

However, a "difference of culture" cannot be used to rationalize negligence with regard to rules and violations. International business is conducted under a certain set of rules and develops when mutual trust deepens as agreements and contracts are exchanged and honored. It became quite clear that there is a marked difference between Japan and the United States in the understanding of this principle. The violation of the reporting duty is a clear violation of a rule. The MOF clearly shows how selfish the Japanese financial system is and how difficult it is for it to be accepted internationally. In that sense, the "Daiwa Bank problem" is a "Japanese problem" as well.

Of course, it goes without saying that it is essential to have open communication and tight cooperation among countries in order to maintain an international financial system. In an age of progressively globalized finances, where money can be transferred within a split second, mistrust between financial supervisory authorities may lead to a financial crisis. We have to conclude that the MOF's understanding of this point was too naive.

The root of this case is in the collaboration between the MOF and the Japanese banking industry regarding the so-called "administrative guidance," which is indistinct and secretive. Such an administrative method delayed healing only to worsen the damage. When it became impossible to hold back the information any more, and the truth was finally made public, a huge irrevocable international and domestic loss of trust resulted. Why then does the Japanese financial industry depend on the "administrative guidance" of the secret room? Why does it not want to act and take responsibility for its own acts?

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73. At a press conference held on September 18 for foreign correspondents in Japan, MOF explained that "the problem resides in the difference of culture." *See Suggestion of Splitting MOF Surfaced Abruptly with Daiwa Bank Scandal; MOF, Campaign of Bureaucracy, Shows Signs of Fatigue*, SHUKAN TOYO KEIZAI, Dec. 2, 1995, at 16 (Japanese-language source).

74. After Japan acknowledged that it had failed to notify American banking authorities for six weeks after it learned of a $1.1 billion scandal at the Daiwa Bank in New York, Treasury Secretary Robert E. Rubin and his Japanese counterpart, Masayoshi Takemura, talked on Oct. 11, 1995 to air their differences. Rubin's aides said that officials of Japan's MOF characterized the conversation as apology, but Japanese officials said in Tokyo on Oct. 12 that no apology had been proffered. *Cloistered Japanese Banks*, N.Y. TIMES, Oct. 13, 1995, at A1.

The first reason is that, since the end of World War II, there have not been clear rules established for the financial world in Japan under which it could act on its own operating principles and take responsibility for its own activities. Rather, it had to adhere to the murky rules of "administrative guidance," whereby it was required to ask what the MOF's intentions are. In this case, for example, there was no explicit rule saying that the Bank had to report within a specific number of days after it learned about such an incident. There was simply a guiding principle that it had to be reported as soon as possible.

Secondly, the reason that such a secretive collaboration between the administration and the industry, and its lack of disclosure, lasted so long are the existence of the so-called "convoy system"[75]—a concept to approve the government backup system as a desirable matter—and the increase in real-estate and stock prices that continued to rise for years and years due to the continuous expansion of the Japanese economy. Under such conditions, it was easier for industry to obey administration policy, as the profit would automatically flow in with the expansion of the Japanese economy. Even if industry officials made a mistake in managing the Bank, the damage would be healed automatically by the rise of the real-estate and stock market prices if they "kept their mouths shut" in collaboration with the administration.

In fact, Daiwa Bank seems to have thought that it was adequate to report the incident to the MOF and simply to obey the guidance of MOF. The MOF, however, did not tell Daiwa Bank what to do in this case. Thus, Daiwa Bank inadvertently broke the IBA's reporting rule that an incident has to be reported within thirty days after it was discovered, and as a result, Daiwa Bank was expelled from the United States

Thirdly, from the international viewpoint, the Japanese financial institutions, despite their limited international experience, have quickly become giants in size during the last ten years, mainly because of a sharp yen appreciation against the U.S. dollar. Their holding increased twofold in terms of the dollar, and the amount of funds they controlled increased sharply. Thus, the Japanese financial institutions, big in size, but rather primitive in international etiquette, felt that they had to depend on the administration's guidance in order to compete among the more sophisticated institutions of the world, which in comparison

75. The treatment of Japanese banks by MOF is best understood by an analogy to a convoy forming a large group consisting of warships, cruisers, and destroyers to ride out rough seas and opposition.

have survived years of tough competition and merger battles while being responsible for their own acts. The MOF's shallow understanding of what the international financial system should be was the true cause of the joint failure of the MOF, on whom Daiwa Bank relied for guidance, and Daiwa Bank to comply with U.S. law.

VI. GENERAL IMPROVEMENTS FOR JAPANESE BANKING IN THE INTERNATIONAL MARKET

What Japan needs is a fundamental overhaul of the Japanese financial administration. Such an overhaul is necessary in order for Japanese banks to be accepted with sufficient respect as a partner of the other world banking institutions. How can Japanese banks be upgraded to an international level qualitatively as well as quantitatively?

The first step should be to reduce government intervention by terminating the secretive government administrative guidance and openly documenting all rules in the form of statutes and regulations. Once this is done, all financial institutions must compete freely on their own initiatives by obeying the rules and not relying on government administration. This means, from the standpoint of the supervising authorities, that the authorities should not interfere in financial operations, so long as the financial industry is operating based on the predetermined rules.

The job of financial authorities should then be limited to monitoring the industry by making sure there are no violations of the rules and examining the financial institutions that operate on licenses to see if their operations are healthy. If the authorities find any violations through such monitoring and examination, the violators should be punished according to a predetermined objective standard. The financial institutions, on the other hand, should actively disclose their assets without waiting for monitoring or examining by the authorities.

In order to introduce these autonomous responsibility principles and free market doctrine, it is necessary to minimize government intervention and its control of industry. Toward such an end, it is better to establish an independent organization in order to monitor the market and enrich its functions.[76] As we

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76. As to this point, Japan can learn from the U.S. banking monitoring system. Each element of the monitoring system in the United States, comprising FRB, Federal Deposit Insurance Corporation (FDIC), Office of Currency Control (OCC), and the banking supervisory bureau of each state, operates strongly

follow this scenario, we come to a possible disintegration of the MOF. The problem is that too much power is concentrated in the MOF.[77] That is one of the distant causes of the Daiwa Bank incident. One idea is to divide the MOF into several units, including a Budget Agency (which would prepare the budget), a Tax Agency (which would plan out the tax system and collect taxes), and an Asset Management Agency (which would manage the national assets among other responsibilities), and to establish separate market-monitoring organizations, thus making the entire organization more efficient.[78]

Naturally, the MOF is expected to resist such a disintegration plan and to try to maintain its existing organization; it seems that the MOF is hoping to overcome the situation by simply beefing up the existing examination divisions in the ministry.[79] It is questionable, however, whether such a patchwork solution can really silence the surging voices that call for MOF reform.

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independent of each other. A drawback of this system is the complexity which stems from the overlapping jurisdictions of the independent elements. Although there is no need for Japan to copy this U.S. system, the Daiwa Bank case demonstrates, that Japan needs a strong, independent bank examination organization consisting of professionals in lieu of the Banking Bureau, which is, after all, a part of the MOF.

77. For example, MOF provides the securities market supervision, which is equivalent to the SEC's function in the United States. This is another reason why MOF needs restructuring. As to this point see Mitsuru Misawa, *Loss Compensation in the Japanese Securities Market: Causes, Significance, and Search for a Remedy*, 25 VAND. J. TRANSNAT'L L. 37, 53-55 (1992).

78. The Administration Reform Project Team of the ruling coalition parties has started the evaluation of a plan to absorb the examination and supervising functions of the MOF's Banking, Securities and International Finance Bureaus into an independent Financial Examination Agency to be newly established. *See* SHUKAN TOYO KEIZAI, Nov. 11, 1995, at 2 (Japanese-language source).

79. MOF has issued an enhancement plan for its financial examinations utilizing the existing means, such as Operations Improvement Orders and budget approval procedures, in response to various criticisms it has received since the Daiwa Bank case. In other words, although it has been handling the results of the examinations through administrative guidance, it will mainly resort to procedures such as administrative sanctions to satisfy the criticisms denouncing the ambiguity of administrative guidance. *See MOF Tries to Maintain Transparency of MOF and Avoid Disbanding of Organization Through Intensified Financial Inspection and Administrative Measures*, NIHON KEIZAI SHIMBUN, Dec. 1, 1995, at 7 (Japanese-language source).

VII. ENFORCING RESPONSIBILITIES OF DIRECTORS—THE DERIVATIVE SUIT

Certain stockholders[80] brought suit in the District Court of Osaka claiming $1.1 billion (¥110 billion) in damages, caused by the loss at the New York Branch of Daiwa Bank, against 38 defendants, including the former chairman of the board, former officers, and the current president and officers of the Bank.[81] The Bank's stockholders originally requested Daiwa Bank's auditor initiate an action against the management of the Bank within thirty days, but the auditor refused to do so. As a result, those stockholders decided to sue the Bank's directors themselves in accordance with the Commercial Code.[82] The stockholder's claim states the following:

> Those directors of the bank failed to take proper measures; they failed to discover the illegal trading by an E.V.P., who was a temporary employee of the New York Branch, for an extended period of time. Moreover, after the illegal operation was revealed by the confession of said E.V.P., they concealed evidence and repeatedly conducted illegal operations, causing substantial damage to the bank. These actions are the directors' violations of their duty of loyalty to the company.[83]

In response to the claim, Daiwa Bank was served an order to be expelled from the United States by the FRB and has agreed to it. It has been reported,[84] however, that the Bank is going to plead not guilty as to the twenty-four crimes, including fraud, claiming that such conduct was not completed by the organization. It is also expected that the Bank is going to plead similarly in the case of the stockholders' representative action in an effort to evade the responsibilities of its directors.[85]

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80. Two individual stockholders and one corporation stockholder.

81. *Stockholder's Representative Action to be Filed Tomorrow Asking 1.1 Billion Dollars in Damages*, NIHON KEIZAI SHIMBUN, Nov. 26, 1995, at 30 (Japanese-language source).

82. *See supra* note 53, arts. 267, 275-74.

83. *See* Nikon Keizai Shimbun, *supra* note 79.

84. The president of Daiwa Bank countered the attack by claiming, "[t]he bank is the victim," at a press conference. It seems what he was trying to say was, "the bank was double-crossed by a trusted temporary employee of the bank and is pursued with a supplementary action, a severe administrative action. Yet, the bank has not caused any losses to befall its clients." NIHON KEIZAI SHIMBUN, Nov. 22, 1995, at 4 (Japanese-language source).

85. However, directors of Daiwa Bank will face a difficult situation in the stockholders' representative action brought against them in Japan because Daiwa Bank itself and Tsuda, the former director and general manager of the New York Branch, have admitted their guilt regarding a number of the charges and agreed to a plea bargain with the U.S. prosecutor. *See supra* note 12.

The stockholders' representative action is a new form of litigation introduced in United States which has not functioned properly in Japan.[86] While the number of stockholders' representative actions is increasing and several judgments have been made in cases where the directors' responsibilities were at issue, it is too early to say that the system operating such actions has been well established. The present $1.1 billion case is drawing much attention from the business circles in Japan due to the size of the claim. Examination of a few other more typical cases appears below.

A. *Case A: Mitsui Mining Co., Ltd.*

In a stockholders' representative action, the directors of Mitsui Mining Co., Ltd. [87] were sued for damages caused by having coerced its wholly-owned subsidiary into purchasing its stock at a high price and then selling the stock to the Mitsui Group at a lower price. The suit alleges that this action violated the rule prohibiting the acquisition of a company's own stock. The Supreme Court, finding that the acquisition of the stock of their own company was a violation of the Commercial Code,[88] rendered a guilty verdict against the directors.[89] Although this representative action requested the payment of ¥100 billion (approximately $1 billion), the Supreme Court supported the

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It is almost certain that the plaintiffs in the stockholders' representative action will use this plea bargain as indisputable evidence of the alleged wrongdoing of the directors. While the opening arguments in the trial of the stockholders' representative action are scheduled for May 1996, the defendants are expected to argue whether the management decision was a correct one at the time of the incident rather than debate the existence or lack of a malfeasance. In other words, the defendants will argue whether the response of the directors to the incident was "extremely unreasonable."

86. In order to make this system function properly, a revision of the Commercial Code was enacted in October 1993 containing: (1) a reduction of the petition fee and (2) allowing plaintiff stockholders to petition for recovery of litigation expenses from the company if the plaintiffs win. (Amendments to the Commercial Code, June 14, 1993, No. 62) (Japanese-language source).

87. A mining concern listed on the Tokyo Stock Exchange. Address: 2-1-1, Chuo-ku, Tokyo. Sales (1995): 249 billion yen. TOYO KEIZAI, JAPAN COMPANY REPORT 48 (1996).

88. According to the Commercial Code, *supra* note 53, a company is prohibited from acquiring its own stocks (Jiko Kabushiki no Shutoko [Acquisition of Own Stock] art. 210). Also, a subsidiary is prohibited from acquiring the stocks of its parent company. The rule recognizes the oneness of the parent company and a subsidiary and applies the rule to the transaction between the two. (Jiko Kabushiki no Shutoku [Acquisition of Own Stock] art. 211-2).

89. Ariyoshi v. Mitsui Mining Co., Supreme Court, Sept. 9, 1993, 1st Small Court, 1989 (o) No. 1400 (Japanese-language source).

judgment of the Second Tokyo High Court that found ¥3.5 billion (approximately $350 million) in damages.

B. *Case B: Hazama-Gumi Ltd.*

In a representative action requesting damages from a director of Hazama-Gumi Ltd.,[90] for a bribe paid to the mayor of Sanwa-machi, Ibaragi-ken by the company, a guilty verdict was rendered by the Tokyo District Court in December 1994.[91] The verdict against the directors ordered them to pay ¥14 million (approximately $140,000) in damages, a sum equal to the amount of the bribery. In delivering the verdict, the Tokyo District Court ruled that: (1) using as a means of business a crime of a highly unsocial nature, such as bribery, should not be tolerated; and (2) bribery cannot be justified as a means of business simply because it brings a profit to the company, it is difficult to get an order without it (as competitors do the same), or it is customary in the industry.[92] The defendants did not appeal the case.

C. *Case C: Nomura Securities*

Before loss compensation procedures became illegal by the Revision of 1991 of the Securities and Exchange Law,[93] Nomura Securities[94] compensated such losses. In a representative action seeking damages against the directors, the Tokyo High Court supported the decision of the first trial by the Tokyo District Court which did not hold the directors liable and rejected the claim by the plaintiff.[95] While it found that loss compensation is an unfair trading method in violation of the Antimonopoly Law,[96] it also decided that the Antimonopoly Law does not fit with the rules concerning the application of the Commercial Code with

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90. A general construction company listed at Tokyo Stock Exchange. Address: 2-5-8, Minato-ku, Tokyo. Sales (1995): 522 billion yen. TOYO KEIZAI, JAPAN COMPANY REPORT 76 (1996).

91. Matsumaru v. Otsu, Tokyo District Court, Dec. 22, 1994, Civil Sec. No. 8, 1993 (wa) No. 18447 (Japanese-language source).

92. *Id.*

93. Securities and Exchange Law, *supra* note 52.

94. A securities broker listed at Tokyo Stock Exchange. Address; 1-9-1, Chuo-ku, Tokyo. Operating profit (1995): 335 billion yen. TOYO KEIZAI, JAPAN COMPANY REPORT 994 (1996).

95. Ikenaga v. Tabuchi, Tokyo High Court, Sept. 26, 1995, 16th Civil Dept., 1993 (ne) No. 3778 (Japanese-language source).

96. Dokusen Kinshi Hô [Antitrust Law], Law No. 54 of 1947, art. 19 (Japanese-language source).

regard to damage caused by a violation of the directors.[97] The reason for this is that the party that receives the loss is not the company, but the competitor. The decision also stated that the loss compensation was within the normal boundaries of the management's judgment, and neither the violation of the duty of due care nor the violation of the duty of loyalty to the company were found.[98] Thus, the directors were not liable.

D. *Standard of Directors' Liability*

The facts of these three example representative actions are completely different. By comparing these three decisions, however, one can deduce the following standard of directors' liability.

First of all, as the decision of the Tokyo District Court stated in Nomura Securities: (1) the management judgment of a corporation is a comprehensive one requiring a professional, predictive, policy-making judgment capability for analyzing unpredictable, fluid, and complex factors, so that it tends to be broad and complex; and (2) a court should examine the actual management judgment of the directors itself from the standpoint of whether there were any careless mistakes in examining the facts that were used as premises, and whether the decision-making process based on the facts was not illogical.[99] In essence, it seems that the court is trying to honor the management judgment of directors as much as possible.

The court, however, considered that directors may be subject to liability in certain situations. First, even if an act may be viewed as an act indispensable for business reasons, the director who committed the act may still be punished if it is an illegal act for which a person can be sent to jail. In the above three cases, bribery can be a criminal offense punishable by up to three years of imprisonment under a Criminal Code,[100] and acquisition of one's own company's stock can be a criminal offense punishable by up to five years of imprisonment under the Commercial Code.[101] On the other hand, loss compensation conducted before

97. Commercial Code, *supra* note 53, Kaisha ni Taisuru Sekinin [Responsibilities to Company], art. 266-1-5.

98. Tokyo District Court, Dec. 22, 1994, Civil Sec. No. 8, 1993 (wa) No. 18447 (Japanese-language source).

99. *Id.*

100. Criminal Code, *supra* note 52, Zouwai, Assen Zouwai [Bribery, Mediating Bribery], art. 198.

101. Commercial Code, *supra* note 53, Kaisha Zaisan wo Ayauku suru Tsumi [Crime to Risk Company's Assets], art. 489-2.

1991 is not a criminal offense punishable by imprisonment, and no penalty rules are applicable to violations of the Antimonopoly Law.

Second, assuming that an act is not a criminal offense, directors will not be punishable simply because they caused a loss to the company, if other directors in the same industry could have made the same mistake.

Third, a director who performs a certain prohibited act or fails to supervise another such a director; a director or auditor who attended the board of directors meeting where the execution plan for such an act was adopted; or an auditor who attended the auditors meeting which examined such a plan may be liable.

E. *Application of This Standard to the Daiwa Bank Case*

Applying these principles, let us review the Daiwa Bank case. In light of the first principle, if the court in New York decides that the action of the directors stationed at the New York Branch at the time of the incident is a criminal offense punishable by imprisonment, then the same directors will be held liable in the representative action in Japan as well. According to the third principle, not only the directors who actually performed the actions, but also the directors who failed to monitor the directors who performed the actions, as well as the directors and auditors who attended the board meeting at which the action was approved face liability.

If such action is not a criminal offense punishable with imprisonment, it should then be examined against the second principle. In other words, if the action of the director that caused a loss to the company is the type of action that would have been performed by many directors in the same industry, the director is not liable. The question is whether the action performed by the directors stationed at the New York Branch can be considered to be the kind of action that would have been performed by many directors in the same industry. The answer to that question is no; the present case is a very unusual case in view of the common sense of the particular industry. Therefore, it will not be a surprise if the directors are held liable, even if the action does not constitute a criminal offense punishable by imprisonment.

In addition, in the Daiwa Bank case, responsibilities of the directors will be evaluated from viewpoints that have never been considered before. For example, is it reasonable to impose supervisory liability on the directors, who resided in Japan at the time, when the incident occurred in New York? The general sentiment of Japanese managers is that "directors who reside in

Japan can not be held responsible for an incident that happened at a place so far away." Even though it happened on foreign soil so far away, it may still be reasonable for the stockholders to hold the directors who resided in Japan responsible for a breach of supervisory duty because of the length of time—eleven years—that they remained unaware of what was happening.

The Japanese should welcome the opportunity brought by the judgment in the present case to think about the responsibilities of directors in the expanding international environment and to clarify these standards of responsibilities.

VIII. ECONOMIC PENALTY PAID BY JAPANESE BANKS

A. *The Japanese Premium*

The phenomenon called the "Japanese premium,"[102] which means that Japanese banks—the banks of the largest creditor nation in the world—are forced to pay interest rates approximately 0.25% higher in the overseas market, is still prevailing with no end in sight. This is because an increasing number of foreign banks are reducing the funds supplied to Japanese banks since Daiwa Bank announced its loss. The fact that Daiwa Bank received an order of expulsion from the United States is not helping end this special treatment of Japanese banks.[103]

In addition to the Daiwa Bank case, a general distrust of Japanese banks lies behind the Japanese premium. Such distrust arises from: (1) the lack of proper information disclosure; (2) the limited supply of public funds that can be diverted to save the financial institutions plagued with bad debts; (3) risks of bad debts due to unclear accounting processes; and (4) risks of unexpected loss disclosures. A view that these problems

102. This is the premium the European and U.S. banks are asking in the interbank market in London and New York when financing Japanese banks. Even the highest ranking Japanese banks are asked to pay interest 0.25% higher than the London Interbank Offered Rate (LIBOR) in case of Euro-dollar one-month items. *Premium Interests for Japanese Banks Escalate in Europe*, NIHON KEIZAI SHIMBUN, Sept. 28, 1995, at 7 (Japanese-language source).

103. According to a forecast by the Sumitomo Life Insurance Research Institute, the total loss by Japanese banks due to Japanese premium will amount to ¥250 billion ($2.5 billion) by the end of March 1996. For details, see *Japan Premium Causes 250 Billion Yen Loss of Profit*, NIKKEI KINYU SHINBUN, Dec. 22, 1995, at 1 (Japanese-language source).

associated with Japanese banks are not transient, but rather structural ones, has settled into the minds of people abroad.

Japanese banks had difficulty in raising funds from abroad in 1974, just after the so-called "first oil shock." The Japanese premium at that time reached 3% at its peak. The rate itself was higher then than it is currently. However, if one compares the total amount of short-term loans in question, it is about $250 billion now compared to $10 billion then; thus, the problem is far more serious now.[104]

The problem then became liquidity (*i.e.*, the credit shrinkage of the Euro-dollar market). As a countermeasure to this Japanese premium, the MOF introduced a regulation in 1977 which stipulated that a certain portion of all long-term assets should be funded by long-term loans.[105] This operating/funding regulation, however, was scrapped in the early 1980s, and it became the norm for Japanese banks to obtain long-term loans for less than 10% of the long-term assets and to rely on short-term loans for the rest. As a result, the increase in short-term funding costs due to the Japanese premium at this time is reducing the lending interest revenues of Japanese banks. The situation is more serious at this time because, in addition to the above-mentioned problem, Japanese banks are plagued with such fundamental issues as management problems and bad debts.[106]

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104. *Dollar Shrinkage Leaves Deep Scar; Tectonic Movement in International Finance Market; Clearly Showing Unreasonable Nature of Japan Premium*, NIHON KEIZAI SHIMBUN, Nov. 24, 1995, at 1. *See infra* Figure 5 (Japanese-language source).

105. *Id.*

106. *Id.*

Fig. 5 Comparison of Japanese Premiums

	1974	1995
Cause	• Closing of Helmschtadt Bank (West Germany)	• Management failures in Japanese financial institutions
Effect	• Interest gaps widened depending on rating and names due to shrinkage of Euro-market's credits creating functions	• Only Japanese banks are burdened with penalizing interests with no regard for rankings and names
Purpose of foreign fund raising	• Settlement of oil purchase cost	• Funds for international investment and financing
Short term foreign currency obligations	• $10 billion	• $250 billion

B. *Effect of the Japanese Premium*

The Japanese premium is economically unreasonable. Japan has an enormous surplus in the trade balance. In order for a country with a negative trade balance to keep trading,[107] the country with a surplus trade balance has to keep financing the country with a deficit trade balance. The United States has a negative trade balance vis-a-vis Japan. Also, the United States has a deficit in the current balance, so that it has to compensate for the deficit with a smooth capital return flow, *i.e.*, a flow of funds from Japan, which has a high foreign currency reserve, to the United States, which has a low reserve.[108] Thus, Japan is a large creditor of the United States.

Japanese banks, the banks of the largest creditor country,[109] have to pay higher interest than others to borrow the currency of

107. *See infra* Figure 6.
108. *See infra* Figure 7.
109. *See infra* Figure 8.

the United States, the largest debtor country; such interest differential is the Japanese premium. In that sense, it is unreasonable. The reason that Japanese banks are paying this high penalty is because banks in other countries expressed distrust about Japanese banks—a distruct that was reinforced by the Daiwa Bank case. Thus, the Daiwa Bank case was a regretful incident and caused profound damage for all Japanese banks.

Fig. 6 Japan's Merchandise Trade with the U.S.A. (1989-1993)

(US $ million)

	Japanese Merchandise Trade			With the U.S.A.		
	Exports	Imports	Balance	Exports	Imports	Balance
1989	275,175	210,847	64,328	93,188	48,246	44,942
1990	286,948	234,799	52,179	90,322	52,369	37,953
1991	314,525	236,737	77,788	91,538	53,317	38,221
1992	339,649	233,021	106,628	95,793	52,230	43,563
1993	360,911	240,670	120,241	105,404	55,236	50,168

Source: KEIZAI KOHO CENTER, AN INTERNATIONAL COMPARISON 34 (1995) (Japan) (Japanese-language source).

Fig. 7 International Liquidities (End of 1993)
(US $ million)

	Total	Gold	SDRs	IMF Position	Foreign Exchange
Japan	99,688	1,164	1,543	8,261	88,719
Germany	82,215	4,575	961	3,951	72,727
U.K.	37,663	886	1860	1,860	34,627
U.S.A.	74,938	12,585	9,023	11,797	41,532

Source: KEIZAI KOHO CENTER, AN INTERNATIONAL COMPARISON 51 (1995) (Japan) (Japanese-language source).

Fig. 8 Japan's Capital Outflow (1989-1993)
(US $ million)

	Long-Term Capital	Short-Term Capital	Total
1989	- 89,246	45,830	-43,416
1990	-53,080	35,140	-21,540
1991	-31,390	-103,240	-71,850
1992	-30,780	-75,770	-106,550
1993	-78,336	-14,426	-92,762

Note: (-) indicates outflow.
Source: KEIZAI KOHO CENTER, AN INTERNATIONAL COMPARISON. 47 (1995) (Japan) (Japanese-language source).

The Japanese premium is expected to continue for some time, because it will be difficult to wipe away the distrust of Japanese banks. Moreover, Japanese banks will encounter some fundamental problems in raising funds from the international market. Specifically, there are three mismatches in the fund-raising by Japanese banks: (1) there is more lending than deposits (lending/deposit mismatch); (2) shorted amounts have been raised in the short-term interbank loan market and applied to long-term assets (short-term/long-term mismatch); and (3) assets and debts have been actively accumulated in foreign currencies, such as U.S. dollars rather than yen, although the yen is the basic currency for Japanese banks (currency mismatch). As a result, while Japanese banks have credits of $481.2 billion (approximately ¥ 48.12 trillion) against corporations overseas, the amount raised by stable means, such as borrowing from banks, is only $177.5 billion (approximately ¥ 17.75 trillion).[110] In other words, they are operating an amount three times larger than the amount raised by stable long-term means, and the shortage of fund-raising is covered with short-term funds.

The Japanese premium can be viewed as reflecting the risks associated with such mismatched deals. In that sense, the Japanese premium will not disappear until the contents of fund trading of Japanese banks—that is, their management attitudes—change. Although higher-ranking banks with high credibility can

110. *Japan Premium, How Will it End?*, NIHON KEIZAI SHIMBUN, Nov. 6, 1995, at 43 (Japanese-language source).

continue international operations despite the Japanese premium, trust banks and local banks will have difficulty maintaining their operations because of negative spreads. In essence, it is expected that overseas assets of Japanese banks will be reduced.

If Japanese banks reduce overseas assets, however, it may cause worldwide credit shrinking. The lending balance of Japanese banks in the United States has reached 9.4% of total lending. Additionally, these banks hold $400 billion in Treasury bonds.[111] Since 1986, Japanese institutional investors have purchased 9.3% of all newly issued U.S. Treasury bonds.[112] These investors have been aggressively buying U.S. Treasury bonds for their high liquidity in preparation for tough times, partly because of the guidance of the Bank of Japan.[113] If the raising of foreign currency becomes difficult, Japanese banks will probably start cashing in the Treasury bonds. If that happens, long-term interests in the United States will increase rapidly, and U.S. stock prices will go down.

In order to prevent world-wide credit shrinking and deflation, the United States has to provide sufficient liquidity and fill this gap temporarily as the last provider of dollars. The FRB recently set up a system to supply short-term funds to Japanese banks against collateral of Japanese foreign currency reserves.[114] This was not only because the FRB was concerned about the effects of the collapse of Japanese banks on the United States, but it was also based on the concern about the possibility of worldwide credit-shrinking, as mentioned above.[115]

IX. CONCLUSION

Economic relations between Japan and the United States have been rough in recent years due to the trade imbalance problem. Various disagreements in thinking were exposed between the two countries in the Daiwa Bank case. This incident provided a new and serious impact on relations between the two countries.

The central issue of this incident is not that an employee of Daiwa Bank engaged in illegal operations, nor is it the huge loss that those operations caused. Those things occur often in both

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111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*

countries, and such a thing cannot cause such a profound impact. The real problems are that Daiwa Bank failed to report to U.S. authorities and that the Bank covered up its losses for a long period of time. Moreover, the MOF failed to notify the U.S. authorities quickly after it was contacted by the Bank. These delays are the reason why the United States is calling the Japanese activities "a serious betrayal of the trust between the United States and Japan."[116] A further problem is that the Japanese, including the MOF, seem to lack any awareness that they may be at fault. "There was no mishandling of the matter," said the MOF. "The reason the Americans are upset stems from the cultural difference between the two countries." [117]

This difference in perspective between the two countries makes this case more complex and multifaceted. It includes an essential problem that cannot be brushed away as a difference of culture. A wide discrepancy exists between the two countries in the way the laws regarding the disclosure system of corporate information are applied. It is mandatory for U.S. corporate management to "disclose important information in the *earliest possible* chance."[118] However, it is quite different in Japan. It is generally thought that a disclosure should be made at a carefully selected, proper timing. Even the MOF considers matters in this way. This misconception between the two countries is really the largest factor that caused this case and created the difference in the perceptions of the seriousness of the matter between the two countries. As a result of that misconception, the handling of the matter by the Japanese was extensively criticized.

Japanese industries should clearly understand that their legal interpretations, as well as people's conceptions and manners of dealing with various matters, while acceptable in Japan, may not necessarily be correct in the United States It is common sense that, as long as one wishes to conduct business in the United States, one should obey the rules of the United States In Japan, we have our own version of the saying, 'When in Rome, do as the Romans do.' This important realization was missing from Daiwa Bank and the MOF.

Japanese companies operating overseas today are all perplexed with a question: to what extent their Japanese way of thinking, *i.e.*, Japanese management style, should be implanted

116. *See* NIKON KEIZAI SHIMBUN, *supra* note 70.
117. *See* SHUKAN TOYO KEIZAI, *supra* note 73.
118. *See* New York Stock Exchange Listed Company Manual, *supra* note 51.

into their overseas subsidiaries.[119] The backdrop to that dilemma is that, although the Japanese management style was highly thought of at one time, more criticisms of it are arising, especially in foreign countries, with the demise of the Japanese economic boom.[120]

The present case clearly shows us how far it is possible to press the Japanese way of thinking and way of handling matters overseas. It is a great lesson, which teaches Japanese companies that there is a limit in applying their management styles on foreign soils. This is especially true of Japanese companies who are undergoing internationalization. It has been nearly ten years since the full-scale internationalization of Japanese industries started. As international corporations, they have gone from being "infant industries" and are now entering the age of maturity. The present case is arguably something Japanese companies are destined to experience as they mature into full-fledged multinational corporations.

Because of this incident, Japanese banks are paying a hefty intangible penalty, namely the loss of trust in the international market. They are also paying a more concrete penalty as well, the "Japanese premium." This penalty against Japanese banks will eventually be born by all Japanese industries. It is necessary for Japanese industries to have a positive attitude and accept these legal, economical, and social penalties, and not try to repel them. Instead, these industries must learn the lessons needed for them to grow further and make a new start. It is also necessary for Japan to rethink the relation between the government and industries, which we have taken for granted until now, and to make necessary changes in our thinking. Restructuring of the excessively large government may be necessary.

The Japanese people must have the modesty to analyze this case thoroughly through multiple approaches and learn whatever there is to be learned. On the other hand, the American people should not repel Japan simply by labeling them "different," but rather understand better the standpoint of the Japanese people and industries who are in the midst of a process of internationalization. Americans should study how the Japanese thought and reacted in this case and should try to understand

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119. For the difference of the management styles, *see* Mitsuru Misawa, *New Japanese-Style Management in a Changing Era*, COLUM. J. WORLD BUS., Winter 1987, at 9.

120. For a recent criticism of Japanese management styles, see Mitsuru Misawa, *Portrait of the International Entrepreneurs* (Interview with Japanese Business Leaders in the United States), SEKAI SHUHO [World Weekly] 44-45 (Jan. 31, 1995) (Japanese-language source).

the Japanese legal, economical, and sociological situations as well. It is desirable, for the further improvement of relations between these two countries to create a consensus regarding international business between them through mutual understanding. In that way, we can find some consolation in this extremely regretful case. As we say in Japan, it is not impossible to turn bad luck into good luck.