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Loss Compensation in the Japanese Securities Market: Causes, Significance, and Search for a Remedy

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ABSTRACT

Recently, the Japanese securities market has been plagued by scandals in which brokerages have compensated large customers for their losses from trading. Following a brief historical review of loss compensation, Dr. Misawa describes the mechanics of a loss compensation scheme. The author then details how rising interest rates caused the losses to clients that brokerages were compensating.

Loss compensation is illegal in Japan. The law prohibiting it, however, is ambiguous as to whether it applies to voluntary compensation. The author suggests the law should be clarified also to prohibit voluntary compensation. Dr. Misawa further recommends that brokerage commissions be liberalized to allow the market to set the commission rates and to prevent the incentive to convert artificially high profits into compensation. In addition, the author suggests the creation of a Japanese equivalent of the United States Securities and Exchange Commission because the current regulatory authority, the Ministry of Finance, and self-regulation have not worked well in Japan. Finally, Dr. Misawa concludes that the Japanese Securities Exchange Law needs to be re-examined and reconstructed to allow the Tokyo market to internationalize further.

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I. INTRODUCTION

Recently, incidents have surfaced in which Japanese brokerages have given compensation to customers for losses in major transactions.[1] This has thrown the Japanese financial world into confusion,[2] and the international ramifications have been enormous.[3] Voices of protest have been heard from many small investors, claiming that this preferential treatment to larger customers is unfair. At the same time, brokerages have been deluged with denials and requests for confirmation by groups and businesses that have received compensation. For the most part, these businesses have responded to the recent revelations with annoyance and have claimed they were unaware they had received compensation.[4]

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1. One hundred eighty-seven companies, including Japanese industry giants Hitachi, Matsushita, and Nissan Motors, as well as public institutions such as Nenkin Fukushi Jigyodan (pension welfare management groups), regional banks, and nonbanks, received compensation for losses from Japan's "Big Four" brokerage houses (Nomura, Daiwa, Nikko, and Yamaichi). *See* NIHON KEIZAI SHIMBUN, July 29, 1991, at 1.

2. Because of this incident, the top officials of some brokerages resigned. For example, Nomura's chairman, Setsuya Tabuchi, and its president, Yoshihisa Tabuchi, both resigned at the same time. *See Namura's Men Dean of Moving Upmarket*, EUROMONEY, July 1991, at 28-37.

3. Concerning the international repercussions of the scandals, see *The Reckoning*, THE ECONOMIST, Aug. 10, 1991, at 70-71; *Under the Volcano*, THE ECONOMIST, Sept. 7, 1991, at 75-76; *While Sleeping Watchdogs Lie*, THE ECONOMIST, Aug. 24, 1991, at 70-71.

4. For example, Nissho Iwai, a company that received four million yen in compensation from Daiwa, said the following: "We of course had no knowledge of being compensated. Maybe the compensation was paid during regular trading. It is annoying that they only announced the names of companies compensated without supplying any details."

Against the background of this denial, these businesses nevertheless argue that department stores give discounts to preferred customers and that, therefore, giving preferential treatment to larger customers makes good business sense.

In this way, the loss compensation problem has engendered numerous debates in Japan. For example, increased call has arisen for an end to the securities regulations by the Ministry of Finance (MOF) and for the establishment of a new government-independent agency like the Securities and Exchange Commission (SEC) in the United States. This Article will examine the origins of the present difficulties, the weaknesses of the current system, and suggestions for improvement. Already, forty-four years have passed since the introduction of the Japanese Securities Exchange Law[5] at the end of the Second World War, which was modeled after United States legislation passed in 1934[6] and 1936.[7] In light of the present difficulties, the suitability of this law in modern society has become questionable.[8]

II. Disclosure of Loss Compensation

Loss compensation occurs when a brokerage compensates a preferred customer following a share deal in which the customer suffers losses, with or without previous arrangement between the two.[9] Although some have said that this occurs on a wide scale, evidence to support or disprove that claim has not yet been brought to light. Recent evidence, however, has been publicized in unexpected ways.

In June 1990, information was discovered that when Nomura declared its taxes for March 1990, it requested reclassification of 16.5 bil-

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Nenkin Fukushi Jigyodan, which received 4.8 billion yen in compensation, said, "There is no reason we should have received compensation, when we have suffered no loss. It is a groundless accusation." C. Ito, a company that received 900 million yen from Daiwa, explains: "We have never requested loss compensation. We only asked that they do something to improve the performance of investments which were doing poorly." For the details of each of these cases, see Shûkan Diamond, Aug. 10, 1991, at 5-9.

5. Shōken Torihiki Hō (Securities Exchange Law), No. 25 of 1948 [hereinafter Securities Exchange Law]. Subsequent amendments to the law reflected developments in the United States. The occupation authorities enacted the Securities Exchange Law at the end of the Second World War as a condition for the reopening of the securities exchanges in Japan.

6. 15 U.S.C. §§ 77a-77mm (1988).

7. 15 U.S.C. §§ 78a-78jj (1988).

8. For an examination of the development of the Japanese securities market, see Mitsura Misawa, *Securities Regulation in Japan*, 6 Vand. J. Transnat'l L. 447-510 (1973).

9. For the precise definition of "loss compensation," see *infra* note 21.

lion yen. Both the National Tax Administration Agency and Nomura admitted that this amount was compensation to preferred customers.[10] As may be seen from this example, a request for reclassification is often used to conceal the destination of funds earmarked for purposes such as loss compensation or political contributions. In other words, when a company files its final tax statement, it later disclaims a certain amount originally calculated as an expense and then redeclares this amount as income. The company then becomes liable to pay taxes for this amount. This, however, usually negates the need for further investigation by the National Tax Administration Agency. This method is one in which a company purposely intermingles its monies.

In addition to Nomura, Nikko requested that 19 billion yen be reclassified, Daiwa requested the same for 12.6 billion yen, and Yamaichi for 1.75 billion yen. Moreover, the tax department investigation revealed that the undeclared and disputed income reached a total of 20.5 billion yen for the four brokerages, with Nomura topping the list at 9 billion yen. This undeclared income includes amounts from previous years and is not limited to compensation paid during the tax period ending March 1990. Daiwa currently has paid 11.8 billion yen in additional tax and penalties, and Yamaichi has paid 8.5 billion yen. Therefore, by the end of March 1990, the four brokerages have paid a total of 90 billion yen—about 700 million dollars—in loss compensation.[11]

This type of loss compensation has occurred in the past. One widely criticized case is that of Daiwa, which was publicized in November 1989.[12] The MOF used the Daiwa loss compensation incident as an opportunity to issue a ban on loss compensation and payment of benefits. Consequently, the MOF issued a concrete policy for the regulation of

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10. The period ending March 1990 was during the zenith of "bubble economics," which will be discussed later in Section IV. Nomura's current profits were nearly 490 billion yen, while profits from securities trading reached nearly 130 billion yen. At this level, loss compensation caused neither pain nor strain. During the press interview at his resignation, Nikko President Iwasaki stated: "Behind the banquet, the devil gently smiles." Perhaps his remark refers to this situation. *See* Shukan Toyo Keizai, July 6, 1991, at 41.

11. *See id.* at 40.

12. In this case, Daiwa lost 10 billion yen in stock deals for 20 to 30 corporations between 1975 and 1980, then compensated them. The operation worked as follows. First, Sankyo Engineering, a securities trading company, took over the customers' devalued stocks. Naturally, it suffered heavy losses. At the end of 1984, however, Daiwa covered this loss by selling Sankyo Engineering 375,000 shares of an affiliate's stock, "Daiwa Building Management," at ¥800 per share. The stock was then resold to a financial institution at more than ¥30,000 per share. In addition, Daiwa paid Sankyo Engineering approximately 600 million yen in "inconvenience fees." *See id.* at 41.

TOKKIN, or special trust funds, a problem that is now receiving considerable attention.[13] The MOF has set March 1990 as the deadline for this TOKKIN cancellation. Incidentally, the bubble stock market price peaked at the end of 1989, crashed at the end of March 1990, and the average stock price fell below thirty thousand yen, dropping twenty-three percent from its high price.

Many TOKKIN suffered tremendous devaluation, and cancelling them in the usual way became impossible. Compensation for losses accompanying the cancellation of such a contract—called "cancellation fees"—became a frequent occurrence. Since the current scandal was the result of rampant loss compensation, examining TOKKIN more closely will be helpful. A TOKKIN is a type of trust fund in which a trust bank invests the capital received from an investor. The investor is free to decide exactly how these funds are to be used: what investment to make, what to acquire, and when to sell. In reality, however, investment decisions are usually left to a brokerage, and major transactions often lay the foundation for later requests for some kind of compensation. The most significant characteristic of TOKKIN is that, in terms of taxes, it allows a company to declare its profits on stock trading according to a stock's listed price instead of its book value. In other words, without using TOKKIN, a company trading stocks must pay taxes on total stock profits, including any hidden profits currently on its books. If a company uses TOKKIN, however, it can trade stocks independently of the book values, making it possible to invest in stocks without the worry of declaring hidden profits. This explains how many corporations and brokerages are drawn into very close relationships through TOKKIN.

III. Mechanics of Loss Compensation

The method of loss compensation employed in the current scandal is both extremely complex and wide-ranging. It is not a simple situation in which depressed stocks were purchased from investors at inflated prices, as in the case of Daiwa.[14] In the present case, face-to-face trading of warrants and unlisted debentures became the tools, rather than listed stocks sold through the stock exchange, which have a clear price.[15] For

13. Japan Ministry of Finance Ordinance No. 2150 (Dec. 26, 1989). The MOF decided TOKKIN were connected to unfair practices such as guaranteeing yields to preferred customers. It then notified the managing director of the Japan Securities Dealer's Association (JASD) about "improving the management posture of brokerages and preventing securities accidents."

14. *See supra* note 12.

15. The JASD, whose membership is made up of brokerages, recently established a

example, if a company had to cover a five billion yen loss, then it would trade one hundred billion yen of unlisted debentures with a one percent margin with the brokerages five times—generating five billion yen. As may be seen from the sophisticated examples below, however, the techniques actually used were not this simple (see Chart 1).

A large business, company A, establishes TOKKIN through brokerage B, with five billion yen to invest in stocks. A drop in stock prices reduces the capital to 4.5 billion yen. Company A demands that brokerage B do something to rectify the situation. And, since brokerage B does not want to lose a good customer, it agrees. So, company A cancels the fund and uses the capital to repurchase 4.5 billion yen in stocks, which it deposits with brokerage B for safekeeping. Brokerage B turns this over to company C as collateral, against which it borrows 5 billion yen. This 5 billion yen is then turned over to company A. Obviously, company A has been guaranteed the principal on its investment and has, in fact, been compensated for its loss.

Company C commonly receives financing from a non-bank D to lend the capital to brokerage B. Financing a 5 billion yen loan with 4.5 billion yen of stocks as collateral is difficult with a regular commercial bank, but it is possible with a non-bank. This can happen because a non-bank anticipates a rise in future stock prices. Brokerage B will then reimburse company C, not only for the 5 billion yen, but also for the interest company C must pay to non-bank D. In the end, brokerage B compensates company A for losses, but that company has avoided any involvement in the transaction. The real participant has been the unnamed company C. For this reason, many unknown companies have been named as major players on the "Big Four's" securities compensation loss list.[16]

IV. Economic Background Leading to Loss Compensation

The current loss compensation problems are a result of the business practices of companies troubled by long-term, easy-money situations and

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self-imposed rule intended to prevent a recurrence of the present scandals. Attempting to set a clear standard for what constitutes regular business as opposed to an act of compensation, the rule establishes: 1) a distribution ceiling per investor of 10,000 shares for newly-issued stocks and of ¥20 million for convertible bonds; and 2) a ceiling of 100 on warrants (rights to subscribe new shares) per investor. The reason for the cap on the distribution of newly-issued securities is that, in many cases, they drastically appreciated in price and were used as loss compensation. *See* NIHON KEIZAI SHIMBUN, Oct. 29, 1991, at 1.

16. *See* SHUKAN DIAMOND, Aug. 10, 1991, at 5-6.

surplus liquidity. In response to solicitations from brokerages, they made large deposits or investments in the form of a discretionary trust, or TOKKIN, thereby leaving the investment decisions in the hands of the brokers. This posed no problems while stock prices remained high. Following a tightening of the money supply by the Bank of Japan, however, stock prices plummeted, exposing the scandals.[17]

After 1968, Japan's international balance of payments was constantly a surplus. Almost daily, the external pressure increased for the upward revaluation of the yen. At that time one United States dollar equalled 360 yen. The Japanese government, however, believed that a stronger yen would lead to sluggish export sales and deflation and therefore worked hard to avoid an upward revaluation of its currency by liberalizing imports. In August 1971, President Nixon announced a policy to protect the dollar. That December, the yen rose, so that one United States dollar equalled 308 yen under the Smithsonian Agreement. Still, Japan's surplus in its international balance of payments continued to expand, and the voices calling for a stronger yen grew louder.

The Japanese government not only lowered interest rates, but also designed a large-scale budget in 1972 and worked to further liberalize imports to Japan, all in an effort to head off another upward revaluation of the yen. Nevertheless, the yen rose so that one United States dollar equalled 260 yen in only fourteen months since the "Nixon Shock." Surplus liquidity, created out of fear of a strong yen and a desire to avoid recession, together with the oil shock that followed, produced inflation in Japan. In September 1985, Japan entered into the Plaza Accords, an agreement by France, Germany, F.R. (West German Republic, prior to reunification), Great Britian, Japan, and the United States (the G5) intended to correct an overstrong dollar. Afterward, Japan cut its official money rate several times in succession and strove to expand domestic demand, which induced a weaker dollar and a stronger yen. As a result, the dollar began to fall of its own accord over time.

In April 1986, the Japanese government, fearing a sudden increase in the strength of the yen, put together the Maekawa Report. The report promoted a change to an international-style industrial structure as a means to restore the fair and equitable position in international balance of payments, increasing faith in areas other than monetary exchange rates. In a joint communique issued that October, Japanese Finance Minister Kiichi Miyazawa and United States Treasury Secretary James Baker announced their intention to put a stop to the devaluation of the

17. For a better understanding of this process, see Chart 2.

dollar and the revaluation of the yen.[18]

The dollar remained at 160 yen and then again declined. In January 1987, the United States Treasury Secretary and the Japanese Finance Minister had an emergency meeting in Washington, D.C., where they reconfirmed the October 1986 agreement. A month later, Japan entered into the Louvre Accords—which intended to stabilize the exchange rates among the G5, Canada, and Italy (the G7)—and lowered its official money rates to 2.5 percent. Subsequently, Japan experienced twenty-seven consecutive months of the lowest interest rates since the end of the Second World War. When Black Monday came in October 1987, supplying the credit needed to maintain stable exchange rates and money market harmony became crucial. Compared to the previous year, the Japanese money supply[19] supported double-digit increases until late 1990. Assets such as stock and real estate simply opened their mouths and waited for the milk of the expanded money supply to begin to flow.

In summary, the extremely low interest rates and easy money that came on the heels of the international cooperation after the 1985 Plaza Accords and prevailed until 1989 created the hotbed that bred the current scandals. The Japanese financial world found confirmation in its mistaken view that Japan's duty is to keep its interest rates down to prevent the worldwide panic that results from a falling dollar. This view was reinforced by the period following Black Monday when the prices of land, stock, and art skyrocketed to unprecedented levels.

Japanese banks lost their sense of moderation in land and other asset-related financing. Brokerages drew the excess liquidity of corporations into the stock market through TOKKIN and other means. After 1990, however, the myth of the eternally low interest rate was shattered. As a result of falling asset values, both banking and securities industries and corporations suffered significant losses, which in turn increased their practice of compensating customers for losses.[20]

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18. This communique was issued on October 31, 1986, both in Tokyo and Washington, D.C. simultaneously. For details, see Nihon Keizai Shinbun, Nov. 1, 1986, at 1-3.

19. The figure is a total of cash, deposits, CD's, and other assets, which are indicated as M2 + CD, in official statistics.

20. As background to the current loss compensation scandals, one should note that excessive company loyalty among the Japanese is undeniable. In fact, it is inevitable in Japanese-style management, which is based on the lifetime employment system. The result of this loyalty is an exceptionally strong desire to minimize respective company losses, both on the side of the one requesting, and the one providing, compensation. For more information on the difference between United States and Japanese management methodologies, see Mitsura Misawa, NEW JAPANESE-STYLE MANAGEMENT IN A CHANGING ERA, COLUM. J. WORLD BUS., Winter 1987, at 9.

V. ILLEGALITY OF LOSS COMPENSATION

As this Article has discussed, loss compensation results from a brokerage's promise to a customer that the customer will not suffer any losses from the buying, selling, or holding of securities. In Japan, compensation paid after a prior arrangement, including vague verbal agreements, is called "guaranteed compensation of loss," whereas compensation paid voluntarily, without previous agreement, is called "loss compensation."[21]

Under United States securities laws, brokerages are prohibited from both the practice of guaranteeing customers against losses in connection with securities trades and holdings, and from the practice of voluntarily compensating customers for losses after they occur.[22] In Japan, Article

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21. In Japan, the broadest definition of "loss compensation" includes both "guaranteed compensation of loss" and "loss compensation."

22. In the United States, the 1934 Act institutes a two-tier regulatory scheme for brokerages: at the higher level the SEC and at the lower level the National Association of Securities Dealers, Inc. (NASD) and the national securities exchanges (so-called self-regulatory organizations). In practice, the regulation of brokers has largely been delegated by the SEC to the NASD and the national securities exchanges. The following is an examination of the applicable rules of the two primary national securities exchanges—the New York Stock Exchange (NYSE) and the American Stock Exchange (ASE)—and the NASD. Under the NYSE's regulatory scheme, customer guaranties and other loss compensation arrangements are governed by NYSE rules 352(b) and 352(c), which provide:

> (b) No member organization shall guarantee or in any way represent that it will guarantee any customer against loss in any account or on any transaction; and no member, allied member, registered representative or officer shall guarantee or in any way represent that either he or his employer will guarantee any customer against loss in any account or on any transaction.
>
> (c) No member, member organization, allied member, registered representative or officer shall, directly or indirectly, (i) take or receive or agree to take or receive a share in the profits, or (ii) share or agree to share in any losses, in any customer's account or of any transaction affected therein. The foregoing will not prohibit the participation of an allied member, a registered representative or an officer in a joint account or investment partnership provided he obtains the prior written consent of his employer.

N.Y.S.E. Rule 352(b), (c), *reprinted in* 2 N.Y.S.E. Guide (CCH) ¶2352 (May 11, 1979). Rule 352(b) categorically prohibits the giving of guaranties covering losses in customer accounts and transactions. The SEC has interpreted rule 352(c) to prohibit a representative of an NYSE member firm from offering to reimburse a customer for trading losses after the transactions resulting in the losses were made. Wallace E. Lin, Exchange Act Release No. 34-27666, 45 SEC Docket (CCH) 544 (Feb. 1, 1990). Given this attitude, the SEC likely would interpret rule 352(c) also to prohibit the actual payment of compensation in the absence of a previous arrangement, although no reported decision on point has been found.

The ASE subjects its members to a separate set of rules. For this discussion, the most

50 of the Securities Exchange Law prohibits brokerages from soliciting customers using guaranteed loss compensation as a sales hook and also prohibits any guarantees made in the absence of solicitation.[23] Guaranteed loss compensation is illegal because easy solicitation of investment as a hook ultimately proves to be unprofitable for the investor. Interfering with fair market pricing by introducing an easy investment decision is a factor in determining that market pricing is contrary to the public interest.

Constant price fluctuations are the nature of any securities market. While this provides opportunities for profit, a chance of a loss always exists. Consequently, a guarantee of compensation against such a loss should not be expected. In many instances, however, brokerages have offered customers the guarantee of loss compensation as a way to get large orders for securities transactions. Although this temporarily may generate an increase in transaction commissions for brokers, when viewed from a long-term perspective, it presents them with a dangerous liability and hurts their sound business operations. Such a guarantee of loss compensation also may invite disputes with customers. On this basis, the Japanese Securities Exchange Law prohibits brokerages and their

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relevant of these is Rule 390, which provides:

> No member or member organization shall guarantee any customer against loss in his account or take or receive directly or indirectly a share in the profits of any customer's account or share in any losses sustained in any such account. For the purposes of this rule the term customer shall not be deemed to include the member or member organization or any joint, group, or syndicate account with such member or member organization.

Am. Stock. Ex. Rule 390, *reprinted in* 2 Am. Stock Ex. Guide (CCH) ¶9420 (May 1, 1975).

23. Securities Exchange Law, *supra* note 5, art. 50.

Under the title of "prohibition of undue solicitation," this article provides:

> A securities company or an officer or employee thereof shall not perform the following acts:
>
> (1) An act of solicitation by offering definitive conclusions regarding the jumping or slumping of prices with respect to stock shares or other fluctuating securities, in connection with transactions such as buying or selling securities;
>
> (2) An act of solicitation by promising customers to bear the whole or a part of a loss suffered by the securities, with respect to transactions such as buying or selling of securities;
>
> (3) In addition to those mentioned in the preceding two statements, actions taken in the buying and selling of securities defined by the Ministry of Finance Ordinance as failing to protect investors, injuring the fairness of a transaction or harming the reputation of the securities business.

Id. (translation by Eibun-horei-sha, Inc. under authorization of the Ministry of Justice and the Codes Translation Committee).

officers and employees from soliciting customers with promises to bear part or all of any losses they may incur from securities and related transactions.[24]

What about the legality of voluntary loss compensation in Japan? To demonstrate clearly that loss compensation has been promised, the existence of contract or some other written evidence is not necessary. The proof at the solicitation stage tends to be an unconvincing and unending circle of accusation and denial. The actual payment of compensation, however, is the strongest evidence that some kind of guarantee was made. Therefore, one must conclude that voluntary loss compensation is a violation of the Securities Exchange Law.[25]

Some, however, believe that although guaranteed compensation of loss is a violation of the Securities Exchange Law, voluntary loss compensation is not because the law does not specifically prohibit it and because an explicit statutory precedent outside Japan for this prohibition does not exist.[26] Still, brokerages giving away large amounts of their own capital for no reason seems unlikely. Rather, one would assume that loss compensation follows a prior guarantee given to a customer.

Consider this example: A customer receives a gift from his brokerage following a loss without any previous agreement. The brokerage's executives could then be held liable for the unjustifiable outflow of cash under the Commercial Code of Japan. In other words, since brokerages are stock corporations, their directors and officers who neglect their duties become liable for compensation of damages to the companies.[27] Further-

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24. *Id.* A violation of article 50 carries no punishment, and the punishment of such a violation is considered administrative. *Id.*, arts. 1(2), 35.

25. In the United States, an "identifiable compensatory transaction" seems to be required. The recent proceedings against Drexel Burnham's Michael Milken focused, in part, on the interplay of the NYSE, ASE, and NASD rules governing customer guaranties and loss compensation arrangements in the context of an alleged offer to compensate customers for losses. In United States v. Milken, 759 F. Supp. 109 (S.D.N.Y. 1990), the court held that, in the absence of an actual compensatory transaction, an alleged offer to compensate a customer for previous trading losses through advantageous future trades did not violate NASD rules Section 19(e), NYSE rules 352(b) and 352(c), or ASE Rule 390 because the manner of consummating the compensatory trades was not specified clearly. *Id.* at 127-28.

26. The MOF takes the position that although Article 50 of the Securities Exchange Law forbids a prior guarantee of compensation for losses, compensation is not a violation of the law since "there is no express provision prohibiting it." In 1989, however, the MOF stated that "because it is inappropriate," such behavior "should be avoided." For details, see SHUKAN TOYO KEIZAI, Sept. 28, 1991, at 28.

27. Under the title "liability to the company," article 266.I(5) of the Commercial Code of Japan (Law No. 48 of 1899) provides the following:

more, directors or others involved in providing this compensation to customers for losses are guilty of special misappropriation in violation of the Commercial Code of Japan and are required to recompense the company for damages resulting from their actions.[28] Consequently, if the compensation cannot be recovered from the one to whom it was given, then the director or others responsible for providing it may be personally held liable for the amount. If company assets are reduced by the act of compensating customers for losses, then company shareholders could bring a derivative suit against those responsible.[29]

> Directors who have done any of the acts mentioned there shall be jointly and severally liable in affecting performance or in damages to the company, in the case of (5) for the amount of any damage caused to the company:
>
> (5) Where they have committed any act which violates any law or ordinance or the articles of incorporation.

SHŌHŌ (Commercial Code), Law No. 48 of 1899, art. 255((5) (translation by author). The Civil Code of Japan (Law No. 39 of 1896) is a related law. Under the title "duty of mandatary, care of good manager," article 644 of this law provides the following:

> A mandatary is bound to manage the affairs entrusted to him with the care of a good manager in accordance with the tenor of the mandate.

MINPŌ (Civil Code), Law No. 39 of 1896, art. 644 (translation by Eibun-horei-sha, Inc. under authorization of the Ministry of Justice and the Codes Translation Committee).

28. Under the title "special crime of misappropriation by directors, etc.," article 486 of the Commercial Code provides:

> If promoters, directors, auditors, acting directors or auditors of a "kabushiki-kaisha" as provided for in Article 258 paragraph 2, Article 270 paragraph 1 or Article 280, managers or any other employees commissioned to undertake certain kinds of matters relating to the business, have inflicted damage of a proprietary nature on the company in breach of their duties with a view to benefiting themselves or any third person or to damaging the company, they shall be liable for imprisonment with hard labor for a term not exceeding seven years or for a fine not exceeding five hundred thousand yen.

SHŌHŌ, art. 486 (translation by Eibun-horei-sha, Inc. under authorization of the Ministry of Justice and the Codes Translation Committee).

29. Under the title "action on behalf of the company to enforce the liability of directors," article 267 of the Commercial Codes provides the following:

> Any shareholder who has held a share continuously at least for the last six months may demand in writing that the company institute actions to enforce the liability of directors.
>
> 2. In cases where the company has failed to institute such actions within 30 days of the date on which the demand mentioned in the preceding paragraph was made, the shareholder may institute such action on behalf of the company.
>
> 3. In cases where irreparable damage is caused to the company by the expiration of the period provided for in the preceding paragraph, the shareholder mentioned in paragraph 1 may immediately institute the action mentioned in the preceding paragraph, notwithstanding the provisions of the preceding two paragraphs.
>
> 4. When the shareholder has instituted an action mentioned in the preceding two

In the United States, customer guarantees also are prohibited by the NASD Rules of Fair Practice.[30] Japan's article 58 prescribes punish-

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paragraphs, the Court may, at the request of the defendant, order him to furnish adequate security.

5. The provisions of Article 106 paragraph 2 shall apply mutatis mutandis to the request mentioned in the preceding paragraph.

Id., art. 267 (translation by Eibun-horei-sha, Inc. under authorization of the Ministry of Justice and the Codes Translation Committee).

30. NASD members are subject to the NASD Rule of Fair Practice. Section 19(e) in Part III of the NASD Rules of Fair Practice prohibits customer guaranties. This section provides: "No member or person associated with a member shall guarantee customer against loss in any securities account of such a customer carried by the member or in any securities transaction effected by the member with or for such customer." Nat'l Ass'n Sec. Dealers, Rules of Fair Practice, art. III, sec. 19(e), *reprinted in* Nat'l Ass'n Sec. Dealers, Inc. Manual (CCH) ¶2169 (1989). The SEC has interpreted this prohibition to cover a guaranty given by a representative of the brokerage in an attempt to induce the customer to make specific trades or to do business with the representative generally. The section 19(e) prohibition also has been interpreted to cover a guaranty given after the acquisition of the securities in question, but before the realization of an actual loss. Curtis L. Wilson, Exchange Act Release No. 34-26425, 42 SEC Docket (CCH) 845 (Jan. 6, 1989). Given these SEC interpretations, the section 19(e) prohibition clearly also would be read to cover similar guaranties given by an NASD member firm.

The reported SEC decisions do not directly address the question of whether section 19(e) would prohibit the payment of compensation to a customer after an actual loss in a situation in which no pre-loss agreement existed between the customer and the brokerage. Even if that section were not interpreted to prohibit that sort of after-the-fact compensation arrangement, section 19(f)(1)(A) of the NASD Rules of Fair Practice most likely still would apply. Section 19(f)(1)(A) provides:

> Except as provided in Subsection (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided, however, that a member or person associated with a member may share in the profits or losses in such an account if (i) such member or person associated with a member obtains prior written authorization from the member carrying the account; and (ii) the member or person associated with a member shall share in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such an account by either the member or person associated with a member.

Nat'l Ass'n Sec. Dealers, Rules of Fair Practice, art. III, sec. 19(f)(1)(A), *reprinted in* Nat'l Ass'n Sec. Dealers, Inc. Manual (CCH) ¶2169 (1989). The most recently reported SEC decision involving section 19(f)(1)(A) concerned the payment of loss compensation to a customer by a broker without any pre-loss arrangement between them. The SEC confirmed the NASD's disciplinary finding that this act constituted the sharing in a customer loss that was not in direct proportion to the broker's financial contribution, which, in this case, was zero. William E. Coxe, Exchange Act Release No. 34-9875, 45 SEC Dec. & Rep. 131 (Nov. 28 1972). The payment, thus, was found to be prohibited under section 19(f)(1)(A).

ment for anyone who employs "any fraudulent device, scheme or artifice with respect to buying, selling or other transactions of securities," meaning that brokerages who pay loss compensation—with or without prior agreement—are violating the law.[31] Proof, however, is required to demonstrate the existence of malice or criminal intent, the applicability of the factors constituting crime, and the illegality of the action in order for this article to be properly applied. Because the investor is insufficiently protected for this reason, article 50 subsequently was added specifically to regulate the actions of brokerages and their officers and employees who play such an important role in securities transactions. Consequently, when brokerages violate article 50, they also violate article 58.

In this way, the Securities Exchange Law takes a particularly severe stance toward brokerages to protect investors, guarantee fairness in securities transactions, and maintain trust in brokerages. Thus, the law was intended to prevent brokerages from engaging in questionable trading activities that would not necessarily be illegal or unethical business practices. Nonetheless, the movement of the securities market is extremely fluid, broad, and complex, and regulations must be carefully framed to suit the precise nature of the prohibited acts. The Securities Exchange Law provides two examples of these acts in clauses 1 and 2 of article 50. As for other activities, clause 3 generally prohibits brokerages, their officers, and their employees from engaging in securities transactions that fail to protect investors, are unfair, or that cause a loss of confidence in the securities industry. The clause establishes a loose framework within which the Ministry of Finance is free to determine what specifically constitutes a violation.[32]

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31. The Securities Exchange Law, *supra* note 5, art. 58. Under the title "prohibition of unfair transactions," this article provides:

> No person shall commit any acts described below:
> (1) To employ any fraudulent device, scheme or artifice with respect to buying, selling or other transactions of securities;
> (2) To obtain money or other property by using documents or any other presentations which contain false statements with respect to important matters, or that omit important facts necessary to avoid deception;
> (3) To make false statements in order to sell or purchase securities or perform other transactions.

Id. (translation by Eibun-horei-sha, Inc. under authorization of the Ministry of Justice and the Codes Translation Committee).

32. According to the ostensible logic of the Securities Exchange Law, this should have been left to self-imposed regulation through the JASD. To maintain the confidence of brokerages, however, fundamental and mandatory rules for brokerages, their officials, and employees have been established by law and ministerial ordinance. Actual applica-

VI. Future Strategies for Improvement

Several steps may be taken to ensure that scandals like the present ones will not occur in Japan in the future. The Securities Exchange Law should be worded to clearly prohibit acts of compensation for loss both with and without previous arrangement.[33] In addition, numerous other measures should be taken. The following two measures should be immediately implemented: brokerage commissions should be liberalized and the MOF's role in overseeing the market must be reformed.

A. *Liberalization of Brokerage Commissions*

Japan's fixed commission system is considered one of the chief causes of the present loss compensation problem.[34] Because brokerages receive a higher percentage in commissions from preferred large clients, covering a deficit for these clients would be logical so they do not suffer losses. In other words, the fixed commission system was established with the protection of less competitive brokerages in mind. This, however, has resulted inevitably in easy and immense profits for major brokerages. Consequently, those brokerages adopted a lenient management style, which allows them to give up a portion of these excess profits to keep preferred customers. This unfair trading practice brought great murkiness and confusion to the securities market.[35]

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tion and interpretation of these rules are found in the regulations voluntarily established by the JPSD.

33. This opportunity was used to try to revise the Securities Exchange Law. The proposed revisions passed the Diet on October 3, 1991 and will be implemented within the year. Issues that should have been regulated by law at the outset, however, have been dealt with by a vague system of MOF "notification," a system whose soundness demands close and immediate scrutiny. Previously, promising a customer compensation for losses was forbidden. Now, however, the law covers both prior promise and voluntary compensation following a loss. Furthermore, a brokerage compensating a customer through a third party such as an investment consulting company is forbidden. Also, under the revised law, a customer requesting compensation is forbidden. Finally, the law forbids entrusting account transactions that amount to total investment decisions to brokerages, as was done with TOKKIN, which allowed rampant loss compensation. For more details, see Nihon Keizai Shimbun, Oct. 4, 1991, at 1.

34. On a small transaction of $1 million, the brokerage would receive 0.9% ¥2,500 in commissions. If, however, the transaction were for ¥100 billion, then this becomes 0.075% ¥785,000. The commission for large transactions is on a decreasing scale. In actuality, any transaction exceeding ¥1 billion has "clear sailing." The commissions are never higher than 0.075%.

35. As for the United States, the harm of fixed commissions was indicated in "The Mutual Fund Study" conducted by the Wharton School, University of Pennsylvania, in 1962. Numerous studies followed this, including two SEC reports: "Special Study of the

The securities industry is opposed to the liberalization of commissions for three reasons. First, it would decrease charges for large transactions and raise those for small transactions. This would harm individual investors. Even if the short term effect is to raise the cost of small transactions, liberalization nonetheless is unavoidable now. Furthermore, when market competition is allowed to operate freely, even high-cost brokerages would seem unlikely to continue to raise their fees. Competition probably would force them to lower fees. In short, an across-the-board increase in brokerage commissions would be unlikely.

Another reason advanced by the industry is that if commissions are raised for small transactions, then the number of individual investors will decrease. While this probably will happen to some degree if commissions are liberalized, most individual investors who pull out of the Japanese securities market do so as a result of neglect by brokerages, as well as systemic causes such as interlocking share holdings among corporations.[36] To offer this problem as a reason to oppose the liberalization of commissions, then, is unpersuasive.

The third argument against liberalization of commissions is that it would result in a price reduction war benefiting only the major brokerages and putting the medium and small brokerages at a competitive disadvantage. This, however, is the general nature of a free market, including the securities industry. For example, medium and small businesses in the manufacturing industry are often toppled by large businesses for that very reason.

In conclusion, the arguments against liberalization are weak. In addition, one must consider the internationalization of the Japanese securities market. On a scale that equals or surpasses that of New York or London, the Tokyo market is no longer closed to all but Japanese investors. It is now an international market, open to investors worldwide.[37] Even from an international perspective, the current trend is towards the complete liberalization of commissions, which is not unrelated to the globalization of the Tokyo market. Beginning in 1968, the United States embarked on the path of liberalization and accomplished it in 1975. In 1986, Great Britain moved towards liberalization. Likewise, the time has

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Securities Market" (1963) and "A Study of Institutional Investors" (1971).

36. The number of individual investors in Japan has been declining for some time. The number of stocks for all listed companies was 26.8% in 1983 and fell to 22.4% by 1988. For details, see MINISTRY OF FINANCE, OKURASHO SHOKENKYOKU NENPO, Okurasho, Shokenkyoku, 1990, at 202.

37. For the internationalization of Tokyo's Market, see Mitsuru Misawa, *Tokyo as an International Capital Market—Its Economic and Legal Aspects*, 8 VAND. J. TRANSNAT'L L., 1 (1974).

come for Japan to do the same to diminish the criticism that Tokyo is a "murky and unfair market."[38]

B. *Necessity of a Japanese-Style SEC*

In light of the present scandal, a demand is growing in Japan for a commission-style regulatory agency independent of the government, analogous to the SEC in the United States. Experience has shown that the MOF's current regulatory system has not worked well enough. Some now say that the MOF's securities administration is an important part of the healthy development of brokerages. This, however, is also the reason why MOF's control at times has been too lenient and why insufficient protection is afforded investors.

In principle, the regulation of securities transactions should be through self-regulatory organizations, such as the Tokyo Stock Exchange and the JASD, even under the Japan Securities Exchange Law. Thus, the MOF's role should be merely supervisory.[39] The main argument for this kind of self-regulation is that it is both practical and convenient. A group that is actually in the securities industry and familiar with its complexities is, if it works, by far superior to any government agency. This is because those in the industry handle securities, including specialized financial products like stocks, and they are able to devise suitable solutions to problems. In addition, self-regulation can create more ideal market conditions by motivating those in the business world to comply voluntarily with the law.

The self-regulatory system in Japan, however, lacks the ability to control cases of suspected wrongdoing, as was evident in the current scandals. Several reasons are apparent for this: First, the Tokyo Stock Exchange and the JASD, the two main self-regulating bodies, are actually

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38. The MOF convened the Stock Trading Commission—the advisory institution for the Minister of Finance—on October 29, 1991 to discuss issues like the liberalization of commissions as a way to prevent scandals such as loss compensation from happening again. Liberalization also has become a topic of discussion among policy makers, and a study has even been requested by the Extraordinary Commission on Administrative Reform (the Gyokakushin), which is the Prime Minister's advisory body. For details, see NIHON KEIZAI SHIMBUN

member organizations. Consequently, they tend to make much of the concept of self-regulation while actually doing very little of it. Second, self-regulation tends to result in disregard for public problems, light penalties for violations, and a reluctance to publicize anything negative about the industry, even when violations have occurred.

Frankly, self-regulation has not worked in Japan as it should. Also, the MOF has failed to supervise sufficiently the securities industry, as well as to investigate and regulate suspected indiscretions. A wide gap separates actual securities transactions from the kind of self-regulated transactions provided for by law. The only way Japan can close this gap under the present conditions is through the intervention of a strong government agency. It first must be determined, however, what the most desirable method of intervention would be.

The question is whether the MOF should continue to regulate the securities industry, but with expanded supervisory powers, or if a new, government-independent organization like the SEC in the United States should be established. In Japan, brokerages must be authorized by the MOF, and the supervision and regulation of brokerages are significant MOF responsibilities.[40] Consequently, setting up a supervisory organization completely independent of the MOF would be unrealistic. The most logical solution would be the creation of an organization that, while enjoying a close relationship with the MOF, nevertheless maintains a certain degree of independence.[41]

40. The securities industry has a strongly public nature. Consequently, the Securities Exchange Law establishes a legal structure in which only companies authorized by the MOF are allowed to conduct business in the securities industry. Not only are qualifications rigorously tested at the time of authorization, but the legal structure provides for a high degree of supervision and direction, which encourages brokerages to maintain these high standards. *See* Securities Exchange Law, *supra* note 5, art. 28.7.

When Japan's authorization-style system is compared to a registration-style system, such as the one used in the United States, the Japanese system clearly requires a strengthening of supervisory regulations. For more information on the United States system, see LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW (1958); EZRA WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS (1965).

41. The Gyokakushin recently has published "Report on the Fundamental Revision of Unfair Trading in Securities and Finance," which introduces a plan for a new investigative regulatory organization. This "securities and finance investigative committee" would be attached to the MOF as a semi-independent or external agency. Similar to the National Tax Administration Agency, it would have a quasi-judicial power to audit and prosecute. It would not have the authority of independent administrative action, however, and would be limited to an advisory role to the Minister of Finance. For details, see SHUKAN TOYO KEIZAI, Sept. 28, 1991, at 41.

In his comparison of United States and Japanese administrative structures, Northwestern University's David Ruder, a former SEC chairman, noted that the key to improving

In short, market supervision somehow must be increased. One must also recognize, however, that excessive administrative intervention can be fatal to the workings of the market. Only when the market reflects the will of many investors can its health be maintained and can its transactions be both fair and free. Excessive administrative interference is harmful to healthy market pricing. Presently, Japan is far from this ideal. Revising its law in a way that would destroy the concept of self-regulation, however, is undesirable and runs contrary to the spirit of the Securities Exchange Law.[42]

VII. CONCLUSION: THE NECESSITY OF A STUDY AS TO THE REVISION OF THE SECURITIES EXCHANGE LAW AND THE SECURITIES ADMINISTRATION

The problem of loss compensation is just the tip of the iceberg for the Japanese economy. Japan now must re-evaluate the applicability of the Securities Exchange Law in the modern world and the validity of the

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the regulation of Japanese securities is not so much the structure of the regulatory agency, as its attitude. He also pointed out the importance of committing sufficient human resources and funds to securities regulation. For details, see NIHON KEIZAI SHIMBUN, Nov. 13, 1991, at 31.

42. Regardless of how strong a new regulatory agency may be, without a fundamental change in the management attitude of brokerages, future scandals will not be prevented. Significantly, each of the major brokerages recently used the newspapers to announce a new management policy to investors, which seems a step in the right direction. Present circumstances demand a pledge to society to correct problems in the attitude of management. For example, an announcement made by Yamaichi in the Nihon Keizai Shimbun stated:

> Yamaichi shall establish an internal ethics committee to foster an industry worthy of the trust of both society and the customer. First, Yamaichi has established a general code of ethics. Hereafter, business activities shall be guided by this ethical standard. We are aware that this is only a first step.
>
> THE YAMAICHI CODE OF ETHICS
>
> 1. Societal Obligation (We are aware of our duty to society as a brokerage and shall work towards the development of a healthy securities market).
> 2. Respect for the Customer (We shall treat the customer with deference and respect).
> 3. Honest and Fair Business Dealings (We shall deal honestly and fairly with all our customers).
> 4. Compliance with the Law (We shall abide by all laws and ordinances pertaining to the securities business).
> 5. Professionalism (We shall strive to increase our level of professionalism in order to meet the needs of our customers).
>
> The time has come for us to change our present course.

NIHON KEIZAI SHIMBAN, Oct. 29, 1991, at 7 (translation by author).

assumptions on which it has been based since the Second World War. That law states that its purpose is to "make issuance, sale, purchase or other transactions of securities fair, and to make the flow of securities smooth, in order to contribute to the proper operation of the national economy and to the operation of investors." Consider the relationship between the first phrase, "to make issuance, sale, purchase, or other transactions of securities fair and to make the flow of securities smooth," and the second one, "in order to contribute to the proper operation of the national economy and to the protection of investors."[43] The first phrase refers to the concrete regulatory objectives of the law, while the second conveys more lofty objectives. One might say that the second phrase serves to justify the first.

As for the second phrase, some believe "the proper operation of the national economy" is the primary goal—taking precedence over "the protection of investors"—and, therefore, that the Securities Exchange Law should be interpreted accordingly. Until now, the MOF's securities regulations, which have mostly protected the growth of brokerages, have been based on this reasoning. The former value of that approach may be seen by the important role it played after the Second World War, an era when both the capital market and securities industry were as yet undeveloped.

Others believe, however, that "the protection of investors" takes precedence over "the proper operation of the national economy." In other words, when investors are protected, the natural result is a flourishing of securities investments nationwide. In turn, this presumedly will contribute to the concentration of funds for industrial capital and to the accumulation of national wealth. Based on this viewpoint, the direct aim of the Securities Exchange Law can only be the protection of the investor, other issues notwithstanding. Yet the premise of this protection is the principle of self-responsibility, which is based on the principle of freedom in contract.

In the recent scandals, compensation for losses was limited to large and preferred investors. This clearly demonstrates that the operation of the Securities Exchange Law sorely neglects the principle of individual investor protection. The time has come to return to fundamental principles and to reconsider seriously how the Securities Exchange Law should operate in Japan's present society. The Japanese securities market is now a part of the larger global market, and the position of the Tokyo market in the international economy continues its remarkable climb.

43. Securities Exchange Law, *supra* note 5, art. 1.

Consequently, the current regulatory system necessarily must internationalize and change in response to the mechanism of the market. When viewed from the perspective of fair pricing and the equitable distribution of social capital, both of which are prerequisites of the international market, the Securities Exchange Law, and the regulations based on it, clearly must be re-examined and reconstructed.

Chart 1. LOSS COMPENSATION TECHNIQUE

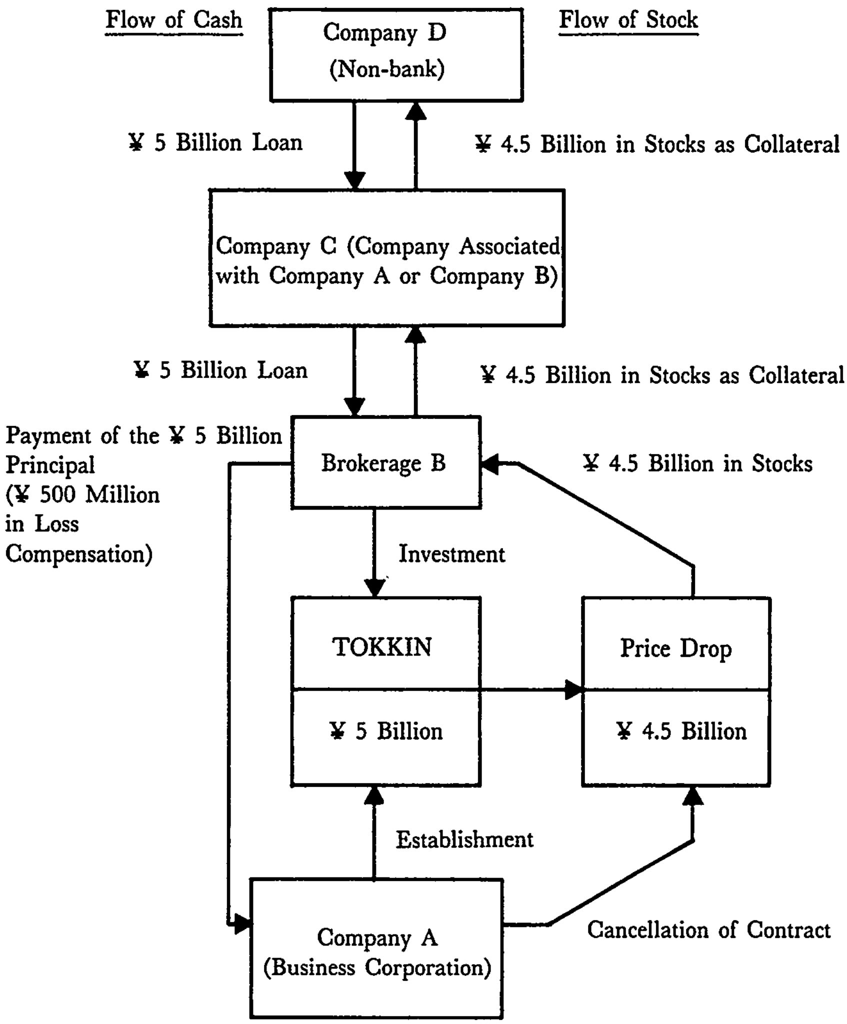

Chart 2. COLLAPSE OF BUBBLE ECONOMICS