Hastings International and Comparative Law Review

Volume 14
Number 2 *Winter 1991*

Article 3

1-1-1991

Differences in Culture, Society, Economics, and Politics and Their Effect on Enforcement of Securities Laws

Wataru Horiguchi

Differences in Culture, Society, Economics, and Politics and Their Effect on Enforcement of Securities Laws

By WATARU HORIGUCHI*

I. PREWAR LEGAL STRUCTURE OF SECURITIES TRADING

The end of World War II saw great changes in the regulations that govern Japanese securities markets. Prior to the war, trading in securities and commodities was regulated under the Exchange Law of 1893 (Law No. 5 of 1893), the Edict Concerning Exchanges of 1922 (Edict No. 353 of 1922), and the Executive Regulations Concomitant to the Exchange Law of 1914 (Ministry of Agriculture and Commerce Order No. 18 of 1914). But on March 12, 1943, as the war was beginning, the Japanese Securities and Exchange Law (Law No. 44 of 1943) was promulgated and became the governing statute for all securities trading. Under the new law, Japan's eleven stock exchanges were disbanded and the government established the new Japan Securities Exchange. Trading on this exchange, however, was halted on August 10, 1945, as the war began drawing to a close.

The role played by the securities market has changed greatly since World War II. Only secondary securities markets were really able to develop before the war. But they were basically speculative in nature, and the market's role as a provider of funds to industry was extremely limited. The main reason for this was the dominant role played by the *zaibatsu* (giant conglomerate corporations) in both the economy and society.

II. THE SECURITIES AND EXCHANGE LAW

During the postwar occupation, the *zaibatsu* were dismantled as part of the Supreme Commander for the Allied Powers (SCAP) policy of democratizing the Japanese economy, and the decision was made to sell massive amounts of stock in *zaibatsu* corporations to the general public.

* Professor of Law, Hitotsubashi University Law School.

In order to raise funds for industry, however, the general public had to be drawn back into the securities market. Securities exchanges were reopened and a secondary market was set up to facilitate the sale of *zaibatsu* shares to private investors.

This created the need for a uniform code for the regulation of securities. In 1947 the Securities and Exchange Law (Law No. 22 of 1947) was promulgated. This law was designed to protect general investors who often had little or no experience in trading securities. The law also dissolved the Japan Securities Exchange on April 14, 1947. The new Securities and Exchange Law was modeled after the American system. It differs from the Japan Securities and Exchange Law of 1943 from the very first article, which discusses the purpose of the law and emphasizes that it is designed to protect investors. This definition of the law's purpose still stands unchanged today. The law establishes reporting systems for the issuance of stocks and bonds, provides for securities exchanges as membership organizations, and sets up a Securities and Exchange Committee. Before the law was ever implemented, SCAP decided that the U.S. system should be introduced to a much wider extent. The entire law was reworked, resulting in the Revised Securities and Exchange Law of 1948 (Law No. 25 of 1948), with only fifteen articles remaining intact from the ninety-two article version of 1947. Japan's Securities and Exchange Act is therefore generally said to have been passed in 1948.

The revised law was created under the orders and supervision of SCAP, and features a more widespread adoption of the U.S. system. While there were numerous revisions, four points are still noteworthy today: (1) the enhancement of the authority of the Securities and Exchange Committee and its establishment as an independent government agency for the administration of the securities system (article 185 and following); (2) the effective prohibition of financial institutions from the securities business (article 65); (3) the prohibition of market manipulation and other similar practices (article 125); and (4) the obligation of insiders to return all short-term trading profits made on their company's stock to the company (article 189).

III. THE SECURITIES EXCHANGE LAW AND CIRCUMSTANCES IN JAPAN

Unlike American securities regulations which grew out of specific needs, Japan's regulations were, to some extent, forced upon Japan. There have been, therefore, numerous problems in adapting the Revised Securities and Exchange Law to the Japanese economy and society, and

there are more than a few regulations which either ignore actual circumstances in Japan or do not suit them.

At any rate, as far as securities regulations and securities trading go, there are special circumstances in Japan arising out of cultural, societal, economic, and political differences with the United States. These differences resulted in a good deal of frustration when first trying to enforce the law, and the law was hindered from functioning as it should.

For example, the requirement of reporting securities issues to the government, first introduced in 1947, represented a substantial change in the Japanese system. At the time, there were many who doubted that the requirement would really assure more protection for investors as the law intended. Rather, the argument went, it would probably be more damaging since the complexity of the procedures involved would discourage issuers from offering and selling new securities. However, experience in the intervening years has shown that, regardless of the original worries, the reporting system has been a great boon to investor protection. At present, in fact, it is the disclosure of corporate information, not the lack of it, that is creating problems.

Another example is the representative suits system, which was not in the Japanese Commercial Code, but was included in article 189 of the Securities and Exchange Law. This was hard for many people to understand, although the problem was eventually solved in 1950 when provisions for representative suits were included in article 267 through article 268, paragraph 3 of the Revised Commercial Code. The provisions of article 189 of the Securities and Exchange Act, however, can only be termed inadequate when compared to those in the Commercial Code. This, along with the fact that article 188 (which required that trading by insiders in their own company's stock be reported and provided the basic assumptions for article 189) was dropped in the revisions of 1953, meant that article 189 rarely functioned. The inclusion of reporting requirements in article 188 as part of the 1988 revisions was an appropriate correction of this fault.

Other differences in legal systems between Japan and the United States have kept the majority of regulations from being as effective as they could be. Further, the law is written in a kind of "translationese" which makes it extremely difficult to understand. And even where regulations exist, many are ignored in actual practice.

All this notwithstanding, the Securities and Exchange Law has been revised over twenty times since its inception, and each time it comes a little closer to what circumstances require in Japan. As a result, it now functions much better than it did previously.

IV. PROBLEMS IN THE SECURITIES AND EXCHANGE LAW AND THEIR SOLUTIONS

One of the reasons that Japan's Securities and Exchange Law has not functioned as well as it could have is that the country has not had a watchdog organization comparable to the Securities and Exchange Commission (SEC) in the United States. A powerful supervisory organization is necessary if the law is to fulfill its stated purpose to protect investors by ensuring fair trading in securities. Prior to 1952 Japan did have a Securities and Exchange Committee which, even if it was not as powerful as the SEC, was an independent administrative agency under the supervision of the Minister of Finance. The committee was not just an advisory organization or commission, but an independent parliamentary agency empowered to create its own regulations similar in force to cabinet and ministerial orders. However, in the government reform that came as the U.S. occupation was drawing to a close in 1952, the Securities and Exchange Committee was disbanded and its authority transferred to the Securities Division, part of the Ministry of Finance's Financial Bureau (presently the Securities Bureau, Ministry of Finance).

Unlike the SEC, the Ministry of Finance does not have the right to make forced searches, and this critical difference is impossible to ignore. Regulations against insider trading were adopted in 1988 with the addition of paragraphs 2 and 3 to article 190, as well as punishment provisions, but they are not sufficient. Critics complain the regulations are too narrow in their application and the punishment is too light. There has been one case of insider trading prosecuted since the adoption of the regulations, but this is only the tip of the iceberg. There are many more cases where insider trading is suspected, but investigations have not been carried out. Therefore, there is a need to broaden the application and increase the punishment for violations of insider trading rules.

Like insider trading, market manipulation has also been mostly ignored by authorities. Market manipulation is prohibited in article 125 and punishments are provided (in article 197, paragraph 2), but the regulations are hard to enforce and need to be reworked. There are several instances in which punishment was levied for market manipulation; thus this area has been more closely regulated than insider trading.

In the 1988 Kyodo Shiryo market manipulation case, which went as far as the appellate court, the Ministry of Finance Securities Bureau began investigating the company and securities house involved, but initially was unable to get an indictment on the market manipulation charge. After the Kyodo Shiryo case, people both inside and outside Japan said that

the takeover bid system should be made easier to use and that owners of significant stakes in companies should be forced to report their holdings. In response to the criticism, Japan revised the law on June 20, 1990, doing away with the requirement that prior notice of take-over bids be given and requiring that any party holding over five percent of the shares in a listed or over-the-counter traded company file a Report of Significant Shareholdings. These changes will take effect soon.

V. PROBLEMS FOR THE FUTURE

It is generally agreed that the principle reason why the United States was unable to suppress market manipulation and make trading fairer in the early twentieth century was that, until it passed the Securities and Exchange Act in 1934, it had no institution similar to the SEC and was consequently unable to create sufficient deterrents. That being the case, Japan made a grave mistake in doing away with the Securities and Exchange Committee in 1952 on the grounds that it was not something to which the country was accustomed.

Considering the fact that the Ministry of Finance has more to do than just ensure fair securities trading and protect investors, one questions whether it is wise to leave the monitoring of securities markets to it. On July 1 the Ministry of Finance established a Securities and Exchange Commission charged with monitoring insider trading and price share manipulation. The commission is composed of seventeen members who, while not having the authority to conduct investigations, are able to report unfair trading to investigative authorities when they discover it. The Ministry of Justice loaned the commission a public prosecutor on July 7. Although the prosecutor works for the commission, the prosecutor will not have the power to conduct forced searches. Thus, while the monitoring system may have been beefed up a bit, it is still insufficient.

The reason that the antitrust laws are able to function at all is largely because of the continued presence of the Fair Trade Commission. That is why it was a grave mistake on the part of Japan to do away with the Securities and Exchange Committee in 1952 on the grounds that it was not something to which the country was accustomed. It does not matter how much laws are revised and regulations strengthened if the laws are not enforced in accordance with the intent behind them. When fine tuning legal regulations in the future, it will also be necessary to make improvements in how the laws are administered, which includes fleshing out the watchdog organizations for securities markets. Therefore, it may be wise to consider establishing an institution similar to the

SEC. This proposal could be criticized by arguing that the creation of a new institution is against the spirit of current government reforms, but the need for government reform should not stand in the way of new things being accomplished.

Japan's Securities and Exchange Law was originally enacted under pressure from the occupying forces. While it has been reformed by Japan since then, one characteristic of many recent changes is that they are again the result of outside pressure. Perhaps this points to the new status Japan has achieved in the world economy, but perhaps it also indicates that Japan will have to rely on outside pressure to get a new watchdog organization put in place.