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Political, Regulatory, and Legal Problems: Focusing on the Securities Banking Fence Issue, Insider Trading, and the Disclosure Systems

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Political, Regulatory, and Legal Problems: Focusing on the Securities Banking Fence Issue, Insider Trading, and the Disclosure Systems

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I. THE FENCE BETWEEN THE SECURITIES AND BANKING INDUSTRIES

In Japan, like in the United States, the securities business and banking operations have been separated from each other under article 65 of the Securities and Exchange Law enacted in 1948.[1] However, article 65 which prohibits banks from participating in securities businesses such as underwriting corporate debentures, includes no explicit provision to forbid banks from becoming affiliated with securities companies. In the United States, section 20 of the Glass Steagall Act expressly prohibits affiliation of banks with securities companies.

The United Kingdom and Canada are trying to channel banking capital, including foreign capital, into the securities industry in order to strengthen the financial capabilities of securities firms and prevent the domestic securities market from becoming "hollow." On the other hand, arguments in favor of a greater role of banks in securities transactions to ensure the profitability of banks are gaining momentum in the United States. In response to these developments overseas, arguments for re-

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1. Article 65 provides:

No bank, trust company or other such financial institution as may be prescribed by an Ordinance of the Ministry of Finance shall do as its business any of the acts set forth in the items of paragraph 8 of article 2: Provided that this shall not apply to cases where any bank buys or sells securities or affects securities index futures trading, securities options trading or foreign market's securities futures trading pursuant to a written order received from a customer for the account of such customer or where any bank, trust company or other such financial institutions as may be prescribed by a Cabinet Order buys or sells securities or affects securities index futures trading, securities option trading or foreign market securities futures trading for the purpose of investment or pursuant to a trust agreement signed with its customers and for the account of such customers in accordance with the provisions of other laws.

moval of the long sustained fence between the securities and banking industries are now being made in Japan as well.

Reviewing the Japanese financial system, the Committee on Financial Systems Research approved a subcommittee report on the proposed removal of the fence between the securities and banking industries, at its plenary session on July 13, 1990. The report recommends letting banks and securities companies enter into each other's market through subsidiaries set up in each other's main sphere of business (sector-by-sector subsidiary approach).

The expected benefits of banks' participation in the securities business may include greater convenience for customers, greater stability for bank management, and more efficient banking operations. At the same time, there is a need to take preventive measures against the conflict of interests and other conceivable ill effects which may result when banks are allowed to concurrently lend money and deal in securities. Thus, various restrictions on the relationship between a bank and its securities subsidiary should be instituted. The restrictions should be designed to prevent the conflicts of interest and malpractice that might otherwise arise from concurrent banking and securities operations, protect investors and depositors, prevent banks from controlling other industries, and ensure the soundness of banking operations. For example, a bank should be prohibited from offering credit to, buying assets from, and providing guarantees for the securities subsidiary. Banks should be prohibited from taking any action regarding securities underwritten by the securities subsidiary. Further, no person should be allowed to hold a senior position in both a bank and its securities subsidiary. No senior level personnel should be interchanged between a bank and its securities subsidiary. The disclosure of certain information should be made compulsory in order to protect the interests of customers. Another issue deserving further study is the implication of ownership of a controlling share in another company by a bank in light of the antimonopoly law.

Even if the policy of allowing banks and securities companies to participate in each other's businesses through their respective subsidiaries is to be basically accepted, the Securities and Exchange Council[2] considers it necessary to leave article 65 of the Securities and Exchange Law intact.

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2. This council was established pursuant to article 165 of the Securities and Exchange Act. Article 165 provides:

> A Securities and Exchange Council shall be established within the Ministry of Finance for the purpose of studying and deliberating on material matters relating to the issuance and trading of securities and other transactions and trading of securities index futures, securities options and foreign market securities futures.

This provision prohibits concurrent banking and securities operations by the same organization. The council also considers it necessary for the legislature to prohibit securities subsidiaries from engaging in securities brokerage for the time being.

II. REGULATION OF INSIDER TRADING IN JAPAN

Japan's Securities and Exchange Law, enacted in 1948, was virtually a verbatim translation of two U.S. laws—the Securities Act of 1933[3] and the Securities and Exchange Act of 1934.[4] Article 189[5] of the Japanese law entitles a company to collect from any officers or major stockholders any profits they may have obtained from the sale of shares in the company within six months from the date of their purchases. Article 58[6] of the same law, like section 10(b) of the U.S. Securities and Exchange Act and rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, prohibits fraudulent malpractice in the sale or purchase of, or any other deal in, securities.

In Japan, however, article 189 was seldom invoked, and article 58, unlike its American counterpart, was generally considered hardly applicable to insider trading. Accordingly, there was no judicial precedent of invoking this provision against insider trading. As a consequence, insider trading was regarded as not illegal and became a very common practice in Japan.

However, as public pressure to make insider trading illegal built up in the United Kingdom, France, Switzerland, Australia, and Canada, and as the securities market in Japan became internationalized, it was no longer permissible for Japan to continue to be an "insider traders' para-

3. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988).

4. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78lll (1988).

5. Article 189 of the Japanese law is similar to section 16(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78p(b) (1988).

6. Article 58 provides:

No person shall perform any act set forth in the following items:

(1) To employ any fraudulent device, scheme or artifice with respect to securities trading, other transactions, securities index trading, securities options trading or foreign market's securities futures trading;

(2) to acquire money or other property by using documents or by any representation which contains untrue statements of material matters or omit any material facts necessary to make the statement therein not misleading with respect to securities trading, other transactions, securities index futures trading, securities options trading or foreign market securities futures trading; or

(3) to use false quotations for the purpose of inducing other persons to buy or sell a security, affect other transactions, securities index futures trading, securities options trading, or foreign market securities futures trading.

dise." Finally, in 1988 Japan's Securities and Exchange Law was partially amended to incorporate new provisions, which expressly prohibit insider trading. The amendment took effect on April 1, 1989.

The new provisions prohibiting insider trading directly follow the judicial precedents which developed in the United States with respect to section 10(b) of the Securities and Exchange Act and rule 10b-5 promulgated thereunder by the Securities and Exchange Commission.

Article 190-2 of the amended law provides that any officer or employee of a company which is the issuer of share certificates or the like listed on the stock exchange, or any other person having a certain relationship to the company who becomes aware of any important fact concerning the business of the company by virtue of his or her office, shall not sell, buy, or otherwise deal in any listed share certificate or the like of the company before the fact is made public. The article further provides that any person having been informed of any such important fact concerning the business or the like of the company by any party connected to the company shall not purchase, sell, or otherwise deal in any listed stock certificate or the like of the company before the fact is made public. The article specifically defines what constitutes an important fact learned in connection with the office in this context and the manner in which the fact is made public.

Article 190-3 provides that any officer or employee of a party making a tender offer or the like, or any other person having a certain relationship to the tender offerer, who becomes aware of any fact concerning the execution or abandonment of the intended tender offer or the like by the tender offerer or the like in connection with his or her office shall not purchase, sell, or otherwise deal in any share certificate or the like which is the object of the tender offer or the like before the fact is made public. The article also prohibits any person who has learned of any fact regarding the execution or abandonment of any tender offer from any party connected to the tender offeror from purchasing, selling, or otherwise dealing in any share certificate or similar item which is the object of the tender offer before the fact is made public. This article specifically defines what constitutes a fact concerning the execution or abandonment of the intended tender offer or the like, and the manner in which the fact is made public.

Anyone violating these provisions is subject to a prison term of not more than six months or a fine of not more than 500,000 yen under item 4, article 200 of the amended law.

One of the characteristics of articles 190-2 and 190-3, discussed above, is the objective and clear definition of what constitutes insider trading. If any officer or any person having a specified relationship to the issuing company becomes aware of a specific fact, his or her dealing in specific securities before the fact is made public will be subject to punishment.

The key elements of insider trading, namely, what constitutes an important fact and how that fact is made public, are objectively defined by the law and by the Cabinet and Ministry orders promulgated thereunder. Once a person connected to the company becomes aware of an important fact under a specific circumstance, whether he or she makes use of or bases his or her actions on the knowledge of the fact is irrelevant. The important fact is deemed to have been made public if the issuing company takes measures specified by the Cabinet order to make the fact available to the knowledge of many persons, even if the fact is not actually known to many persons. The time at which the fact is made public can thus be objectively determined.

Among the recipients of inside information, only the primary recipient or recipients are held liable with a view to preventing the liability from extending indefinitely. The existence of any personal gain of the insider in the transmission of inside information and any breach of fiduciary duty to anyone are not required for an act to be deemed insider trading.

There is no express provision concerning whether or not a public investor, having suffered a loss owing to illegal insider trading, can bring a private civil action for damages. This will be settled by judicial precedents.

The first case of suspected violation of the prohibition on insider trading in Japan was uncovered by the Metropolitan Police Department in connection with the equity capital increase of Nisshin Kisen, a shipping company whose stock is listed in the second section of the Tokyo Stock Exchange. Nisshin Kisen allocated new shares to third parties in June 1989. A former president of a financing company was one of the third parties to whom the new shares were allocated. He was alleged to have taken advantage of inside information and bought Nisshin Kisen shares in another person's name before the announcement of the capital increase.[7]

This scandal involving Nisshin Kisen shares had been investigated by the Tokyo Stock Exchange and the Ministry of Finance, but both had found no wrongdoing. Neither the Tokyo Stock Exchange nor the Min-

7. The violator was fined 200,000 yen by summary judgment in September 1990.

istry of Finance is authorized to make compulsory investigations; thus, their capability to detect violations is limited.

Japan had a Securities and Exchange Commission in the early postwar period, but it was soon abolished as the administrative commission system, which had been transplanted from the United States, did not suit the Japanese bureaucratic soil. Even if it is unrealistic to expect the revival of the Securities and Exchange Commission, an effective system to control and monitor insider trading should be established by joint governmental and private initiatives.

III. DISCLOSURE SYSTEMS UNDER THE COMMERCIAL CODE AND THE SECURITIES AND EXCHANGE LAW

A. Disclosure Under the Commercial Code

The Commercial Code, which includes corporate law, prescribes a disclosure system for joint stock companies in general.

The Code requires that the notice of convening an ordinary general meeting of shareholders be accompanied by financial statements (the balance sheet, income statement, business report, and proposals relating to the disposition of profits or the losses), and the statutory auditor's auditing report. If the company is valued at five hundred million yen or more, or if the company's liabilities exceed twenty million yen, an auditing report prepared by an independent certified accountant or incorporated accounting firm is required. The Code further requires that the originals of these financial statements be retained at the corporation's headquarters for five years, and that copies be kept at branch offices for three years from the day of the pertinent shareholders' meeting. Any shareholder or creditor can demand access to or copying of any such document at any time during the business hours of the company. The balance sheet, and the income statement, if the company is large, should be published either in whole or in summary in a newspaper designated by the articles of incorporation.

Any company having one thousand or more voting shareholders is required to attach prescribed reference documents to the notice of convening a general meeting of the shareholders, and to send absentee ballots to shareholders who will be absent at the meeting. The absent shareholders can exercise their votes with these ballots. This absentee voting system was introduced by the amendment of the Commercial Code in 1979. It replaced the old system under which absentee shareholders voted by proxy.

Any shareholder holding shares constituting one-tenth or more of the total outstanding shares is entitled to demand access to or copying of all account books and documents.

B. Disclosure Under the Securities and Exchange Law

The disclosure system under the Japanese Securities and Exchange Law, introduced in 1948, was modeled after that of the U.S. Securities Act of 1933 and the Securities and Exchange Act of 1934. It requires two types of disclosure.

First, every time a company makes an offering of securities worth five hundred million yen or more, the company is required to file a registration statement to the Minister of Finance and deliver a prospectus directly to each investor.

Second, a company must make ongoing disclosures by filing reports, including an annual report (securities report), a semiannual report, and interim reports from time to time.

In 1979 a new system requiring a registration statement of tender offers was established, followed in 1982 by the introduction of a system of consolidated financial statements. In 1987 an integration formula was instituted to permit the use of the annual report and the semiannual report in the registration statement. Further, the items to be included in various prescribed forms were reviewed. More detailed consolidated information was required with respect to financial information, and a funds flow statement was introduced.

In 1988 a reference formula and a shelf registration formula were introduced for use in the registration statement. The reasons for requiring the presentation of an interim report were increased, and a system of segment information disclosure was also introduced.

The segment information disclosure was new to Japan, but had already been established in the United States, the United Kingdom, Canada, and Australia, to require companies to disclose profit and loss information of their business activities with respect to each line of business and the locations of the parent company and subsidiaries. International accounting standards regarding the disclosure of segment information had also been publicly announced in 1981.

More recently, in June 1990 a partial amendment of the Securities and Exchange Law[8] introduced the five percent rule, which requires any

8. In this amendment, a new provision relating to the international cooperation between securities regulating agencies was adopted. New article 184-2 provides that when a request for cooperation in connection with an administrative investigation by a foreign securities regulat-

purchasing bid in excess of five percent outside the securities market to be made only by a tender offer, and requires any shareholder with a holding in excess of five percent to submit a large holding report to the Minister of Finance.

ing agency is received, the Minister of Finance may order any person concerned to submit records and a report.