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Securities Malfeasance in Japan: The Need for an Independent Organization to Monitor Insider Trading, Price Manipulation, and Loss Compensation

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I. INTRODUCTION

Japanese stock market transactions have traditionally been replete with illegal and unfair practices such as insider trading and price manipulation. Recently, loss compensation has also become a problem. When the Japanese stock market crashed and the bubble economy burst approximately two years ago, many large institutional investors sustained heavy losses and demanded illegal loss compensation from securities companies. Anxious not to lose major clients, many securities companies complied with the demands of the institutional investors. The payment of loss compensation created a heated political controversy in Japan, because while many institutional investors were absolved of personal responsibility for their losses, individual investors had to absorb the losses they had suffered in the stock market crash. A 1990 amendment to the Securities and Exchange Law will alleviate the problem of loss compensation for the time being. However, the amendment was hastily made, and more comprehensive changes to the Securities and Exchange Law are necessary to prevent the recurrence of loss compensation in the future. Furthermore, the problem of loss compensation has been exacerbated by the manner in which the Ministry of Finance supervises securities firms and the stock market. The Ministry of Finance maintains too close a relationship with many securities firms to regulate the problem of loss compensation effectively.

This Article discusses Japanese regulation of insider trading, prohibition of price manipulation, and prohibition of loss compensation. It recommends methods to supervise the stock market and to eliminate malfeasance in securities dealing.

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II. REGULATION OF INSIDER TRADING

In Japan, regulations contained in Securities and Exchange Law section 189 prohibit insider trading, stipulating that officers or principal shareholders must forfeit to the company any profits from the short term trading of their company's shares. Insider trading is also prohibited by Securities and Exchange Law section 58(1), which is identical to American Securities and Exchange Act section 10(b) and Rule 10b-5. However, section 58(1) is difficult to apply to Japanese insider trading because of a difference between the U.S. and Japanese codes of procedure. Accordingly, insider trading has long been a problem in Japan, and it has not been effectively regulated. Therefore, various other countries have criticized the Japanese stock exchange as being a hotbed of insider trading.

The Tateho Kagaku Kogyo incident brought the need to regulate Japanese insider trading to the forefront and led to an amendment to the Securities and Exchange Law in 1988. As amended, the Securities and Exchange Law requires officers and principal shareholders to report trading of their own company's stock (section 188), provides the rules regarding surrender of profits from short term trading (section 189), prohibits trading by persons related to public buyers (section 190(2) and section 190(3)), and establishes new penal regulations. However, the conditions required to establish a violation of the amended Securities and Exchange Law are too particular, and the penalties (under 6 months imprisonment or fines of under ¥500,000) are too light. It is evident that these regulations are insufficient and too lenient to eradicate the problem of insider trading.

Only two instances of insider trading in Japan have as yet been exposed. The Nisshin Kisen K.K. (now Shiikomu) was one such incident. In 1989, Nisshin Kisen purchased the Sidney Regent Hotel in Australia. Capital was to be raised by an allocation of new shares to a third party, and a related source investigated the potential success of a new stock subscription. President "A" of a finance company, who knew of the allocation, used his knowledge of a capital increase and of the names of contacts to purchase 7,000 shares of Nisshin Kisen stock. After an investigation, the Ministry of Finance and the Tokyo Stock Exchange rendered a verdict of "innocent." However, the Metropolitan Police Agency made a separate investigation and filed a complaint on April 22, 1990. The Tokyo prosecutor's office brought a summary indictment in the Tokyo Summary Court on September 26. The Tokyo Summary

Court handed down a summary order of a ¥200,000 fine on the same day.

"A" was indicted under section 190(2), which prohibits the trading of listed stocks by any person knowing important facts about the affairs of a company prior to the public announcement of a company's decision to issue new shares. Ordinarily, the board of directors decides whether to issue new stock. However, in this case only two or three people, including the president of Nisshin Kisen, made a third party allotment. "A" purchased shares on June 15, prior to the board of directors' June 16 decision. Consequently, it became suspected that "A" had prior knowledge of important facts.[1]

The second instance of insider trading involved Makurosu and was prosecuted by the Ministry of Finance on April 26, 1991 in Tokyo Court. Makurosu, an industrial machine manufacturer listed on the Touhsou Second, made a fictitious transaction of ¥4 billion. The company disclosed the fictitious transaction at the end of September 1990, but "B," the managing director, had sold off 22,000 shares in the company under his own and his wife's names on September 3 and 4, thus avoiding losses due to the drop in value of the stocks. The stock values of the company were ¥1400 per share at the time of the sale, but dropped to ¥930 when the overhead trade was made public and fell to ¥490 by the end of the year. This is a typical example of insider trading and "B" 's behavior was inexcusable.

These incidents are just the tip of the iceberg. In many instances, insider trading was suspected, but no formal accusations were made. In order to effectively regulate insider trading, it is necessary to reconsider the requisite conditions and the contents of the penal regulations under the current law. Furthermore, regulation of insider trading needs to extend beyond the current coverage of listed stocks to cover over-the-counter stocks as well.

III. PROHIBITION OF PRICE MANIPULATION

Like insider trading, the problem of price manipulation has gone largely unregulated. Although there are regulations preventing price manipulation (Securities and Exchange Act sections 125(1) and (2), and

1. In another situation, the Ministry of Finance's investigation of whether there was insider trading at the time of the merger of Taiyo Kobe Bank and Mitsui Bank only considered trading conducted after the Board of Directors' decision. The investigation excluded trading that occurred between the agreement of the heads of both banks to proceed with the merger and the Board of Directors' decision. Actually, stock prices rose somewhat before the Board's decision was made.

197(2)), in practice these regulations have rarely been applied because the conditions necessary for the prohibition of price manipulation under sections 125(1) and (2) are too vague. Furthermore, the rules are difficult to apply. Rather than eliminating the provisions, however, it is appropriate to reform them. These types of reforms have rarely been made in the past, largely due to the reluctance of administrative authorities. Recently, an attempt at reform was made, but ultimately failed because of political objections.

By contrast, the penal provisions against price manipulation have been applied in a number of instances. In this respect, price manipulation is controlled more effectively than insider trading. Some examples are the Tokyo Shoken Kinyu company incident (Tokyo Court December 7, 1981, judicial precedent no. 1048 item 164) and the Kyodo Shiryou K.K. incident (Tokyo High Court July 2, 1988, High Court vol. 41 no.2 item 269, original judgment July 31, 1984, judicial precedent review no. 1138 item 26). However, in the case of the Kyodo Shiryou incident, in which the appeal trial judgement on price manipulation was handed down in 1988, the Ministry of Finance Securities Bureau originally investigated the Kyodo Shiryou and the securities firm based on a suspicion of fluctuation control. The investigation did not result in an indictment. In another case, the defendant Otani Mitsuhiro, who represented the stock speculation group "Koutsuu," was prosecuted in the Tokyo Court in 1990 for controlling prices of Fujita Kankou stocks.

Current laws prohibiting price manipulation apply only to the securities listed on the stock exchange. As with insider trading, legislation should be extended to cover the over-the-counter market as well.

IV. PROHIBITION OF LOSS COMPENSATION

Similar to the regulations dealing with insider trading and price manipulation, the 1991 legal reforms prohibiting loss compensation also include penal sanctions for violations. At the time of the 1960 reform, section 50 was instituted, providing that securities firms or their directors or employees may not take specific actions. Section 50 was directed at the relatively frequent incidents of impropriety between the securities firms and their customers. However, because it was undesirable and, in fact, impossible for the law to address every type of possible abuse, a degree of discretion was left to the Ministry of Finance. Consequently, when the problem of loss compensation arose, which could not be prohibited by notification, it could be prohibited by the reform of ministerial orders. Perhaps this might be a sufficient means of handling legal re-

form. However, under this makeshift system of prohibition by notification, deeds performed in disregard of a notification are often ignored by the Ministry of Finance. Technically, loss compensation is prohibited, and securities firms that provide loss compensation and their customers who accept it can be punished (sections 20(2), 199 (1)-(5), 200 (3)(3)). However, the punishments for violator companies and customers are too light.[2]

V. STRENGTHENING THE MONITORING SYSTEM

The above circumstances make it necessary to establish an effective system to monitor securities dealings. Former Prime Minister Kaifu directed the provisional administration reform commission (hereinafter Koukakushin) to develop such policies, including the establishment of an independent monitoring organization. It was foreseeable that these steps would result at best with something resembling the National Tax Administration Agency.[3] Nevertheless, the report of the Koukakushin established a Securities and Financial Inspection Committee based on section 8 of the Administrative Organization Law, which dealt with monitoring securities and financial trading. The final report was not as strict as the original proposal, however, because the Ministry of Finance feared that a more stringent report would reduce its power.

The Securities and Financial Inspection Committee of the Gyoukakushin (the current name of the committee that monitors securities trading) monitors malfeasance in the securities and financial markets, mandates compulsory investigations by authorities, makes recommendations for administrative disposition by the Ministry of Finance, and has jurisdiction over routine investigations. The Committee can make tentative evaluations, but the Ministry of Finance still has investigative authority. The Committee does not have punitive authority and is not a completely independent organization. In these respects, the Committee is insufficient. Additionally, because the report itself leaves many of the finer points undefined, it is necessary to await future legislative action in order to truly evaluate the Committee. Currently, the Ministry of Finance is also proceeding with organizational reform.

2. Violators face less than a year in prison or a fine of less than ¥1 million. Customers face less than six months in prison or a fine of less than ¥500,000, and then only if they have demanded the loss compensation from their brokers. Thus, customers are not punished at all if their brokers voluntarily provided loss compensation.

3. Japan's National Tax Administration Agency is an extra-ministerial department of the Ministry of Finance and is not an independent body.

VI. PREVENTING SECURITIES MALFEASANCE

Although the monitoring organization wields some strength through the licensing system, the Gyoukakushin committee is not powerful enough by itself. As the numerous securities scandals make clear, the source of the problem is the so-called convoy licensing system. In order to completely prevent securities malfeasance, a committee that is independent from the Ministry of Finance must be established. The potential establishment of an organization like the SEC has been criticized, because many believe that the current licensing system of the securities industry and an organization like the SEC cannot coexist. A second look at the licensing system to investigate whether or not it can coexist with an organization like the SEC is presently being urged. Ideally, the door to the securities industry can be opened wide by an advance registration system, under which securities firms can compete freely, advantages can be retained, and disadvantages can be reduced. Unfortunately, the use of a licensing system at the time of the 1960 reform restricted the freedom to commence business. Considering the circumstances at the time, autonomous control was not appropriate, and the use of a licensing system was a step in the right direction. However, given the modern conditions of securities trading, the licensing system is no longer sufficient. The Ministry of Finance authorities should be barred from excessive interference. Currently, the Ministry of Finance tends to honor licenses that have been issued and is reluctant to punish licensed securities firms for fear that punishment will lead to problems of deteriorating financial resources in the future. This fear is somewhat justified, particularly in the case of loss compensation. Although purposeful supervision regulations are provided, in practice they are not well applied.

A powerful independent organization like the SEC is necessary in order to regulate securities firms and other participants in the securities world so as to best protect public investors. This independent organization should be able to monitor the stock market and take preventive measures to nip any detected securities malfeasance in the bud before it becomes serious.

Today, internationalization is promoted in many areas. Since the securities monitoring system is one such area, uniformity of the securities monitoring mechanism of each country is necessary. The current Japanese monitoring system, which only serves to protect vested interests, will impede the integration of Japanese securities into the emerging international market and make it difficult for foreigners to take Japanese regulatory agencies and securities firms seriously.

VII. CONCLUSION

As the Japanese securities market becomes integrated into the emerging international market, outside pressures from the United States authorities and the United States securities market will help encourage reforms. However, a strong, independent organization like the SEC must be formed in order to ensure fairness in Japanese securities trading and to protect the interests of investors.