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# Reforming Japan's Securities Markets: The Loss Compensation Scandal

C. Jeffrey Char†

*One of the worst scandals in Japan's recent history was revealed in the summer of 1991. Seventeen of Japan's major securities companies had secretly compensated select clients for trading losses. Between October 1988 and March 1992 these securities companies made loss compensation payments in excess of \$1.73 billion. In response to the "loss compensation scandal" Japan's Securities Exchange Law (SEL) was amended to prohibit such compensation.*

*This article analyzes the underlying problems in Japan's securities market which were manifested in the loss compensation scandal. The author critically examines the 1991 amendment to the SEL as a response to the scandal. The article then reviews various proposals for reforming Japan's securities market that would effectively address the underlying problems.*

## I.

### INTRODUCTION

Early in the summer of 1991, the leading Japanese financial newspaper featured an article alleging that several of Japan's largest securities firms had secretly compensated select clients for trading losses. This article triggered a chain of events which ultimately led to (1) the disclosure that more than 17 securities companies had in fact made payments in excess of ¥225 billion (\$1.73 billion)<sup>1</sup> to favored clients, (2) the resignation of Japan's Finance Minister and numerous corporate executives involved in the scandal, and (3) various penalties being meted out to securities companies.<sup>2</sup> Against this

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1. All figures in this paper assume an exchange rate of ¥130=\$1.

2. After the Ministry of Finance investigated the scandal, securities companies announced the resignation of a few top executives, voluntary pay cuts for some executives, and changes in

background, and in response to the apparent lack of an effective statutory scheme preventing the recurrence of such compensation, the Japanese Diet amended the Securities and Exchange Law ("SEL")<sup>3</sup> to make such payments, or requests for such payments, illegal.

The central premise of this paper is that in view of the then existing statutory scheme and remaining underlying structural problems of Japan's securities markets, the 1991 Amendment to the SEL was unnecessary and counterproductive. The amendment attacks the symptom instead of focusing on the basic underlying problems. Hence, the purpose of this paper is to stimulate additional reflection on the underlying structural problems of Japan's capital markets in order to produce a more satisfactory long-term solution.

Part II of this paper analyzes the underlying causes and effects of the loss compensation scandal. Part III examines the recent amendments to the SEL and their effect. Part IV offers various proposals for addressing the underlying problems manifested in the loss compensation scandal. The in depth analysis in these parts indicates that the loss compensation scandal was brought about by a combination of numerous structural deficiencies plaguing Japan's capital markets, and that such problems can and should be remedied in order to promote the future viability of Japan's capital markets.

## II.

### ANALYSIS OF THE LOSS COMPENSATION SCANDAL

How and why did the loss compensation scandal arise? There are many institutions and practices that can share the blame. It should be noted from the outset that although the public has come to refer to this incident as the "loss compensation scandal," more than just loss compensation (*sonshitsu hōten*) is involved. In particular, the weight of the evidence would seem to support allegations that securities companies gave guarantees of specific returns (*rimawari hoshō* or *nigiri*) or principal (*sonshitsu hoshō*) to favored clients, presumably prior to entering into securities transactions.<sup>4</sup> In addition,

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sales procedures. In addition, the Ministry ordered some branch offices temporarily closed. However, no documents were ever publicly disclosed and no individuals were prosecuted. (Hereinafter, footnote information not cited to a particular source is within the personal knowledge of the author as obtained from confidential sources. These sources include a senior officer in the corporate finance department of a Big Four securities company, a member of the legal department of another Big Four securities company, and a bond trader at a second-tier securities company.)

3. Shoken Torihikiho [Securities and Exchange Law], Law No. 25, 1948, (as amended 1991) [hereinafter SEL]. See *infra* Appendix B for full text of amendments.

4. Allegations that securities companies guaranteed returns or principal were never proven or officially recognized by the securities companies or the Ministry of Finance. Nevertheless, the pattern of payments by securities companies suggests the existence of such guarantees. According to Ministry of Finance internal documents, approximately 80% of the cases between September 1988 and March 1990 involving payments of ¥1 billion (\$7.69 million) or more were excessive in that: (1) no losses actually existed; or (2) payments exceeded the amount of any losses. For example, in the fiscal year ended March 1990, Nomura Securities paid Showa Shell

the loss compensation scandal entered a second phase in early 1992 with the revelation of the *tobashi* disputes.<sup>5</sup> For purposes of simplicity and familiarity, however, I will refer to this incident in its entirety as the "loss compensation scandal."

In order to appreciate the issue of loss compensation as well as the more fundamental structural problems which were the underlying cause of the present scandal, a general understanding of the history and nature of Japan's securities markets is necessary.

### A. *The History of Loss Compensation & Guarantees*

Perhaps the most interesting facet of the loss compensation scandal is that it actually evolved into one of the worst scandals to rock Japan in recent history. Prior to the unfolding of this scandal, most market participants, and even the public at large, were well aware of the established practice of compensating important customers for trading losses.<sup>6</sup> Why, then, did the scan-

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Oil ¥3.215 billion (\$24.73 million) despite losses of only ¥1.068 billion (\$8.22 million) on its ¥35 billion (\$269.23 million) *eigy tokkin* account, thereby in effect allowing Showa to realize an annual yield of 6.1 percent. Moreover, Nikko Securities contributed ¥1.446 billion (\$11.12 million) to the massive ¥22.216 billion (\$170.89 million) Police Union fund despite the lack of any losses. The Police Union made a modest profit of ¥79 million (\$608,000) for the fiscal year ended March 1990, which gave them a yield of 6.8 percent after taking into account Nikko's payment. In addition to these cases of "excessive" compensation, there were four cases, such as Hitachi and Daiichi Finance, in which the amount of compensation was exactly equal to the amount of losses suffered. NIHON KEIZAI SHIMBUN, Sep. 28, 1991, at 1, 7.

5. *Tobashi* refers to the practice of window-dressing a client's account by transferring investments with unrealized losses to enable the client to avoid declaring investment losses at the end of its accounting period. Under Japanese accounting practices, securities investments must be valued at the lower of book value or market value (*teika ho*). Such transfers were usually effectuated by the securities company locating another client, typically one with a different fiscal year, to purchase the securities at artificially high prices in order to erase or minimize any loss for the first client. Under an agreement at the time of the transaction, the securities company promised that the securities would be repurchased later at a higher price by another client, the securities company itself, or in some earlier cases, the original seller. *Soko Nashi Numa — Kabugen "Tobashi" no Kozu [Bottomless Pit: The Composition of Tobashi Transactions]*, SHUKAN TOYO KEIZAI, Mar. 21, 1992, at 38-41. For example, in April 1991, Maruman Securities arranged for Tokyu Real Estate Loan Guarantee Co. to purchase stock worth less than ¥1 billion (\$7.69 million) from an affiliate of Kawasaki Steel for ¥1.9 billion (\$14.62 million). In order to persuade Tokyu to participate in this transaction, Maruman reportedly promised to repurchase the stock after six months with an 11 percent return. NIHON KEIZAI SHIMBUN, Mar. 10, 1992, at 1. Most other *tobashi* cases are almost identical and point inescapably to the conclusion that Article 50 of the pre-1991 version of the SEL was indeed violated.

6. In November 1989, Daiwa Securities admitted to compensating 20-30 corporate clients for trading losses incurred between 1975-80 in excess of ¥10 billion (\$76.92 million). Stefan Wagstyl, *Daiwa Securities Accused of Hiding Trading Losses*, FIN. TIMES, Nov. 28, 1989, at 29. In July 1990, the Tokyo Regional Taxation Bureau claimed that more than ten Japanese securities companies compensated favored clients in excess of ¥20 billion (\$153.85 million) for losses suffered after the October 1987 "Black Monday" stock market crash. *Firms Fined for Making Up Customers' Stock Losses*, REP. FROM JAPAN, July 30, 1990, at 1; *Financial Skulduggery in Tokyo: The Taxman Always Knocks Twice*, THE ECONOMIST, Aug. 4, 1990, at 66. The latest example of securities companies providing loss compensation to clients prior to the present scandal was in February 1991 when Nomura Securities, Daiwa Securities, and Nikko Securities confirmed that they had purchased share warrants with no present market value from their clients.

dal take on the proportions that it did at such a late date? Perhaps the main reason for this had nothing to do with loss compensation, but with other questionable activities made public at the same time.<sup>7</sup> However, it seems the real reason lies not in the new knowledge that the loss compensation scandal brought, but in the old knowledge that it made impossible to suppress from consciousness any longer. The loss compensation scandal brought to the surface a chronic condition of malaise and confusion within Japan's capital markets. This was a condition of which many had been cognizant, including the Ministry of Finance officials in charge of regulating the markets.

### 1. Legal Framework

The SEL is the main law restricting the compensation of losses in Japan. The SEL was modeled on both the Securities Act of 1933 ("Securities Act")<sup>8</sup> and the Securities Exchange Act of 1934 ("Exchange Act")<sup>9</sup> of the United States. Thus, the SEL regulates not only the primary issuing market, but also the secondary trading market. In addition, it is also the primary source of law for the regulation of securities dealers organizations, securities exchanges, and securities financing corporations.<sup>10</sup> To supplement the provisions of the SEL, there are numerous subordinate regulations, including the Securities Exchange Law Enforcement Order<sup>11</sup> and numerous Ministry of Finance ("Ministry") ordinances of varying significance thereunder.<sup>12</sup>

Securities companies are further regulated under the Ministry's licensing system.<sup>13</sup> Separate licenses exist for brokerage, dealing, underwriting, and distribution of securities. This system effectively limits new entry and gives the Ministry additional power to regulate securities companies.<sup>14</sup>

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FIN. TIMES, Feb. 6, 1991, at 33. In addition, loss compensation on a smaller scale has a long history. The press is replete with stories of favored clients being offered "ambulance or rescue stock" by securities companies in compensation for prior losses.

7. On June 21, 1991, in conjunction with their admission of compensation Nomura Securities and Nikko Securities also admitted to having paid ¥4 billion (\$30.77 million) for worthless memberships in a golf club owned by Inagawa-kai, Japan's second-largest crime organization. FIN. TIMES, June 22, 1991, at 22. Moreover, it was later reported that Nomura manipulated the stock of Tokyu Corporation causing its price to more than double in the Fall of 1989, thereby allowing Susumu Ishii, the former head of Inagawa-kai, to realize huge profits on the 29 million shares he had acquired in the company with the loans from Nomura and Nikko. James Sterngold, *Nomura Gets Big Penalties*, N.Y. TIMES, Oct. 9, 1991, at A1.

8. 15 U.S.C.A. §§ 77a-77aa (West 1982 & Supp. 1991) Securities Exchange Act of 1933 [hereinafter Securities Act].

9. 15 U.S.C.A. §§ 78a-78kk (West 1982 & Supp. 1991) Securities and Exchange Act of 1934 [hereinafter Exchange Act].

10. 2 Japan Bus. Guide (CCH) ¶65-100 (1991).

11. Cabinet Ordinance No. 321 (1965) (Japan).

12. 2 Japan Bus. Guide (CCH) ¶65-100 (1991).

13. SEL, *supra* note 3, arts. 28 & 29.

14. A securities company may apply for more than one type of license, and all of the securities companies involved in the loss compensation scandal were licensed in each category of business. See *infra* note 77.

Prior to the scandal and subsequent amendment of the SEL, the substance of the prohibition on loss compensation and guarantees was provided in Article 50 of the SEL. Specifically, securities companies, their officers or employees, were prohibited from engaging in the following activities:<sup>15</sup>

- (1) soliciting a securities transaction by offering a definitive prediction that the price of a security will rise or fall;
- (2) soliciting a securities transaction by promising to compensate all or part of any loss; or
- (3) any other act prescribed by an ordinance of the Ministry of Finance which undermines the credibility of the securities industry.

Thus, at the time of the scandal, Article 50 itself did not flatly prohibit *ex post facto* payment of loss compensation. It barred such payment only if it was promised prior to an investment transaction.<sup>16</sup> Therefore, the practice of making payments to compensate clients' losses after the fact was not technically illegal. However, the securities companies clearly violated a Ministry of Finance directive. Following Daiwa Securities' admission of loss compensation in 1989, the Ministry issued a circular notice on December 26, 1989, prohibiting loss compensation regardless of the existence, or nonexistence, of a prior promise.<sup>17</sup>

Surprisingly, no express civil or criminal sanctions existed for violation of Article 50. Violators were merely subject to administrative sanctions.<sup>18</sup> Similarly, violation of a circular notice is not illegal *per se*. However, such a violation can put a securities company on bad terms with the Ministry, and may lead to administrative sanctions against the firm.

## 2. *The Act of Compensating*

Guarantee payments were frequently made indirectly, through securities transactions, although a few involved direct payments of cash.<sup>19</sup> Warrants and foreign bonds were by far the most common vehicles for effectuating payment, accounting for nine out of ten such cases. The popularity of these instruments was due to their underdeveloped trading markets which made it difficult to establish market prices.<sup>20</sup> In a typical loss compensation transaction, a securities company sells bonds or warrants to an investor at below market prices, and promptly buys them back at higher prices.<sup>21</sup> Another

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15. Summary of SEL, art. 50. For full text of provisions, see *infra* Appendix A.

16. See, e.g., *supra* note 4.

17. Ministry of Finance Circular Directive No. 2150 (1989) (Japan).

18. Conduct that violates antifraud provisions of the SEL subjects violators to criminal penalties. Wataru Horiguchi, *Regulation of Broker-Dealers*, in *JAPANESE SECURITIES REGULATION* 95 (Louis Loss et al. eds., 1983).

19. See *infra* Appendix E.

20. According to internal Ministry of Finance documents, securities companies employed an array of methods in effectuating payments, including cash, warrants, newly issued convertible bonds, stocks, index futures, foreign bond STRIPS, Japanese government bonds, and Japanese government bond futures. *YOMIURI SHIMBUN*, Sept. 28, 1991, at 1.

21. Prior to the establishment of Japan's warrant market in September 1990, Eurodollar-denominated warrants were only traded among securities companies, with the trading price being

variation was to sell stock with a promise to repurchase at a later date and at an appreciated price (*kabushiki gensaki*).<sup>22</sup>

Promising to compensate trading losses and guaranteeing a target return reallocates risk from the investor to the securities company. The only significant difference between promising to compensate losses and guaranteeing specific returns is the level of risk: yield guarantees are more risky since a current liability arises as soon as the guarantee is made, whereas loss compensation guarantees are contingent liabilities which arise only if losses occur.

As shown in Part II.B. below, the major reason securities companies offered such promises, and agreed to assume such risks, was to develop and maintain lucrative underwriting, brokerage, and fund management business from corporations. Consequently, investors unable to provide these types of incentives to securities companies were unable to receive these benefits. In addition, fixed brokerage commission rates meant that brokerage business from large institutional investors was artificially profitable. To this extent, loss compensation payments can be viewed as rebates. Furthermore, since the fixed commission structure did not generate proportionately hefty profit margins for low volume transactions, there was no economic incentive for securities companies to offer these investors compensation. Accordingly, one commentator pointed out, "equal treatment of customers can imply unequal prices."<sup>23</sup> Consequently, the act of promising loss compensation or guaranteeing returns might not be inherently unfair or immoral.

However, even assuming that there is nothing morally wrong with promising to compensate losses or guaranteeing returns, the transactions used to effectuate these promises created at least three collateral problems. First, a preconceived plan to incur trading losses by selling low and buying high is in conflict with a securities company's dealer function. Arguably, such action constitutes a breach of management's fiduciary duties of loyalty and care. Second, the compensation may affect the reliability of a securities company's accounting system and records. In order to maintain the secrecy of the transaction, these transactions were improperly entered in the securities companies' books in violation of accepted accounting rules and disclosure requirements. In short, such falsification undermines the disclosure process.<sup>24</sup> Third, in many cases, loss compensation payments were improperly

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publicized by each securities company. Prices varied greatly from one securities company to another, and investors could not discern the fair warrant price except by calling each securities company separately. *Tokyo Warrant Market "Eliminates Difficulties"*, INT'L SEC. REG. REP., July 16, 1990, at 4. Similarly, with the exception of a few bellwether issues, secondary trading in most bonds remains thin and prices volatile.

22. This was a common device used in *tobashi* schemes. See *supra* note 5.

23. Terry A. Marsh, *A View from the U.S.: What Does Equal Treatment of Customers Mean?*, TOKYO BUS. TODAY, Aug. 1991, at 8.

24. See, e.g., Philip J. Keuper, Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation through the Federal Securities Laws*, 43 BROOKLYN L. REV. 681, 709-43 (1977).

declared by the securities companies and their clients, and many companies were later ordered to pay additional taxes.<sup>25</sup>

### *B. Underlying Structural Factors*

In total, 17 of Japan's major securities companies compensated 354 of their favored clients to the tune of approximately ¥225 billion (\$1.73 billion) during the period from October 1988 to March 1992.<sup>26</sup> The reasons behind the compensation payments differ. The most common explanation, and the one used by securities companies to justify their actions, is that such compensation was demanded by major clients who had experienced investment losses. However, there are cases in which securities companies voluntarily paid compensation to favored clients in reflection of the client's overall importance. It is clear that not all clients who received compensation actually demanded such compensation. In fact, in numerous cases, the client may not have even been aware of being compensated. The primary issue, however, is not who demanded compensation, but rather why the securities companies compensated clients at all. The answer to this question is indispensable to reforming Japan's capital markets.

#### *1. Market Domination By the Big Four*

A total of 220 Japanese securities companies were licensed to operate in 1991.<sup>27</sup> These securities companies can be roughly divided into three tiers according to their relative size. The first tier is comprised of Nomura Securities, Daiwa Securities, Nikko Securities and Yamaichi Securities. These firms form what is known in the industry as the "Big Four." The second tier is comprised of ten medium-sized securities companies, most of which are affiliated with one of the Big Four or one of Japan's major banks.<sup>28</sup> The third tier is comprised of the remaining securities companies which, although large in number, are significantly smaller in terms of capital, revenue, and income. In addition to these three tiers based on size, fifty-two foreign securities firms of various sizes form a fourth group.<sup>29</sup>

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25. See Fumiko Fujisaki, *Japan Brokerage Scandal Widens to Smaller Firms*, REUTERS, July 22, 1991, available in LEXIS, Nexis Library, REUTERS File; See, e.g., NIHON KEIZAI SHIMBUN, July 4, 1991, at 1.

26. ASAHI SHIMBUN, July 15, 1992, at 1. This figure does not include dispute settlements. According to a senior Ministry of Finance official, a total of 235 legal actions involving securities companies were filed between January 1991 and March 1992. Damage claims totalled ¥31.49 billion (\$241.62 million) of which ¥20.25 billion (\$155.77 million) were against the Big Four. [*Stock Trouble, Since Last Year 235*], NIHON KEIZAI SHIMBUN, Mar. 5, 1992, at 7.

27. JAPAN SEC. RESOLUTION INST., SECURITIES MARKET IN JAPAN 159 (1992) [hereinafter JAPAN INSTITUTE].

28. For example, the Nomura group owns 32.2 percent of Kokusai Securities and the Yamaichi group owns 37.4 percent of Taiheiyo Securities. 4 KAISHA SHIKIHO 920-21 (Sept. 25, 1991).

29. JAPAN INSTITUTE, *supra* note 27, at 229.

The Big Four effectively dominate trading on Japan's securities markets. In 1989, the Big Four directly accounted for a total of forty percent of all trading on the Tokyo Stock Exchange.<sup>30</sup> Furthermore, if all second and third tier affiliates were added in, their share would swell to sixty percent or more.<sup>31</sup> Due to their oligopolistic position and a bull market in the 1980s, the Big Four were able to achieve massive profits through their underwriting, brokerage, fund management, and dealing activities.<sup>32</sup>

More importantly, the Big Four benefitted greatly over the last four decades from the establishment of the cross-shareholding system in Japan.<sup>33</sup> In addition to the underwriting commissions for arranging the issuance and sale of new shares to affiliated or group companies, the securities companies also profited from their access to inside information.<sup>34</sup> In Japan, stock prices of companies that plan to raise funds on the capital market (*fainansu meigara*) almost always rise. It is widely known that when a Japanese company is preparing to issue new securities at market price,<sup>35</sup> its underwriters will often collude to artificially raise the market price of the issue in order to allow the issuer to raise funds at a more favorable price and lower overall cost.<sup>36</sup> Investors, for their part, attempt to ascertain which corporations are in the process of financing in order to purchase the shares in anticipation of such underwriting manipulation and a rise in price.<sup>37</sup> Analogously, securities companies are

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30. *Patterns and Implications of Japanese Stockholding*, 3A JAPAN ECON. INST., Jan. 25, 1991, at 6.

31. *Id.*

32. For the fiscal year ended March 1990, the Big Four posted net income of ¥582 billion (\$4.48 billion) on revenue of ¥2.8 trillion (\$21.54 billion). 4 KAISHA SHIKIHO 913-14 (Sept. 25, 1991).

33. See ROBERT J. BALLON & IWAO TOMITA, *THE FINANCIAL BEHAVIOR OF JAPANESE CORPORATIONS* 114 (Kodansha International 1988). Most publicly-held Japanese corporations hold shares of affiliate or group companies. In the 1960s, corporate managers began to enter into cross-shareholding agreements in order to protect against the threat of hostile takeovers. The cross-shareholding system accelerated in the 1970s in response to the liberalization of laws restricting foreign ownership of Japanese corporations.

34. Despite the industry-wide implementation of so-called "Chinese walls," or separation between a securities company's corporate financing and brokerage activities, a high degree of collusion between the two continues to exist. There are still personnel policies which place emphasis on developing generalists rather than specialists, leading to frequent interdepartmental transfers. In addition, living in company housing and dormitories, commuting to work, and socializing after work with fellow employees all facilitate the rapid flow of information to the point where Chinese walls work in theory only.

35. It was a common practice among Japanese corporations to issue new shares at par value through rights offerings. After 1969, however, offerings at market price have gained in popularity and now are the principal method of paid-in capital increase. JAPAN INSTITUTE, *supra* note 27, at 36.

36. Such activities go far beyond permissible market stabilization pursuant to SEL art. 125. For example, in 1987, Mitsubishi Heavy Industries (MHI) issued a convertible bond through Nomura Securities. MHI's share price shot up from 420 to 670 in the two month period preceding the issuance, and later fell back to the 400 range after the issue was successfully distributed. *Land of the Rising Stocks*, FORBES, May 18, 1987, at 139.

37. In theory, when a firm raises capital by issuing additional securities at the market price, it increases its outstanding shares and dilutes its price earnings ratio, which in turn will often

able to profit from their inside information by purchasing shares for their own account, and subsequently recommending the stock to favored clients.

At the same time, the Big Four's ability to successfully "ramp" share prices in connection with the underwriting of such issues creates an increased incentive for issuers to select the Big Four for underwriting. In fact, one of the reasons why few corporations ever select a non-Big Four securities company as their lead underwriter is that they want to issue new shares at the highest price (and lowest cost) possible, and they realize that in general, only the Big Four are capable of providing this "service."<sup>38</sup>

Other practices which gained the Big Four a high degree of notoriety were the sales quotas (*noruma eigyo*<sup>39</sup>) and sales campaigns behind their high pressure sales tactics. The key strength behind each of the Big Four is their massive and effective retail sales forces.<sup>40</sup> Such placement power virtually guarantees their ability to successfully underwrite an issue in the primary market.

In addition, these sales forces are able to promote certain issues, industries, sectors, and themes in the trading market.<sup>41</sup> Sales campaigns are similar to share price ramping prior to a new offering and often begin with a securities company accumulating the shares of a certain company for its dealer position. The securities company subsequently recommends the share to a few favored clients, such as clients who previously suffered losses,<sup>42</sup> and

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lower the share price. Hence, most investors think of equity financing as a negative factor, unlike in Japan.

38. See Tetsu Ishida, *Jiko Kaikaku ni Katsuro Motomeru Shoken [Pursuing Reforms in the Securities Industry]*, in *NIKKEI FAINANSHARU* 92 (1991), 119-20.

39. Securities companies impose monthly sales targets or quotas on each branch office or sales department. The Big Four are notorious for their hard sell tactics, and salesmen are not allowed to take no for an answer. Salespeople's careers depend on their successfully maximizing commissions. Non-producers are stigmatized and considered unqualified. On the other hand, salespeople who meet or exceed their sales quotas are promoted to higher positions and their reputations follow them for the rest of their careers. Recently, this practice of emphasizing sales quotas has moderated due to the loss compensation scandal. *NIHON KEIZAI SHIMBUN*, Mar. 30, 1992, at 15. Ironically, however, while the Big Four have supposedly toned down the use of such tactics, a number of second-tier firms have actually stepped up such tactics in an effort to take market share from the Big Four.

40. For example, Nomura Securities has a sales force comprised of 4,600 retail brokers and another 3,000 saleswomen. *FIN. TIMES*, June 29, 1991, at 4.

41. For example, "triple merit stocks" (stocks which stood to gain from declining interest rates, lower oil prices, and a weaker dollar/stronger yen), "waterfront stocks" (shares of companies involved in the development of Tokyo Bay), and "domestic demand-related stocks" (shares of companies which securities companies expected to benefit from a shift in the economy toward increased reliance on domestic demand and away from an export-oriented tradition) were some of the compelling campaign themes of the late 1980s. *ASAHI SHIMBUN*, Nov. 15, 1991, at 2. A senior economist at Japan Securities Research Institute commented that "using themes is the only way the Big Four brokers know how to sell stocks, and following the Big Four is the only way the small brokers know how to do business." Emiko Terazono, *Scandals Dash Recovery Hopes—Brokers Face the Worst Slump Since the 1960's*, *FIN. TIMES*, Mar. 27, 1992, at 6.

42. See *supra* note 6.

politicians,<sup>43</sup> and ultimately issue a "strong buy recommendation" to the general public. Next, the sales force is mobilized to stoke investor interest in the issue which by this time has risen in price due to the insiders' earlier purchases, thereby fulfilling their predictions. At the next stage, insiders sell into the rising market and realize hefty returns. Investors high enough up on the information chain thus are able to profit by getting in and out of the market before it peaks. After the frenzy subsides, the unsupported share price drops, and the securities company, through its investment trust affiliate, steps in to purchase the shares for its investment trusts at bargain prices.

As a group, individual investors are chronic losers at this game. They are the farthest down on the information chain, and therefore, are most likely to buy near the top of the market and wind up at the bottom. Unfortunately, these sales campaigns continue to appeal to the speculative impulse of many individual investors. In turn, sophisticated investors are willing to participate in this game because they know that less sophisticated individual investors will follow.

## 2. Fixed Commissions

Among the three major stock exchanges of the world, the Tokyo Stock Exchange is the only one to maintain fixed commission rates.<sup>44</sup> In New York and London, brokerage commissions are set through negotiations between the broker and the investor. The Ministry of Finance has long argued that the fixed commission rate structure is vital to the survival of the small security company.<sup>45</sup> This system was singled out by many industry critics as being at the core of the scandal,<sup>46</sup> however, and the Ministry has been forced to reevaluate its position.

In contrast to fixed brokerage commission rates in the trading market, rates for underwriting and distributing securities in the primary market are not officially regulated. In practice, however, the major securities companies have colluded to maintain such commissions at profitable levels.<sup>47</sup> For example, under the present cartel system, the commission rate for an equity offering of ¥1 billion (\$7.69 million) is 3.1% or ¥31 million (\$238,462).

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43. "Political stocks" are sold to politicians to provide funds for expensive election campaigns and provide a sophisticated means of avoiding cash payoffs.

44. SEL, *supra* note 3, art. 131 provides that the regular members must collect commissions from customers as set by the exchange for the execution of sale or purchase order on the exchange. Article 130 provides that the schedule of commission and the method of collection must be prescribed in the Brokerage Agreement Standards of the exchange. The Brokerage Agreement Standards stipulate not only the schedule of commissions (*See infra* Appendix G), but also the method of collection.

45. *Requirements for Liberalization of Commissions*, NIHON KEIZAI SHIMBUN, Dec. 31, 1991, at 8.

46. *See, e.g., Kaizuka, Shoken Tesuryo "Kaizen Jiyuka" Ron [A Commentary on Complete Liberalization of Securities Commission Rates]*, in SHOKEN KAIKAKU 41-58 (1991).

47. At present, the underwriting commissions for stocks range from 2.9% to 3.1%, while underwriting commissions for corporate bonds range from 0.45% to 1.2%.

However, if the issue is increased to ¥100 billion (\$769.23 million), commissions soar to approximately ¥2.9 billion (\$22.31 million). According to a report by the Japanese Federal Trade Commission ("JFTC"), the primary reason securities companies offered clients compensation was to win their lucrative underwriting business.<sup>48</sup>

The fixed commission rates for brokerage transactions create a similar result, although the scaled-rate structure reduces the excessive profits on large trades to some extent. For instance, a small-lot trade of ¥900,000 (\$6,923) would cost the investor ¥10,350 (\$79.62), or 1.15% in commissions, while an institutional investor placing a ¥10 billion (\$76.92 million) order would pay ¥7.5 million (\$57,692), or 0.075% in commissions. The actual cost differential to the securities company between the two trades, however, is marginal.

The effect of the fixed commission rates structure on competition is deceiving. One of the problems with the present fixed commission rate structure is that it is set up to protect the weakest securities companies. Rates are set to enable even the most inefficient securities companies to survive. Under this system, there is no economic incentive for these securities companies to increase their efficiency. Thus, on the surface, the fixed commission rates structure seems to inhibit competition. Nevertheless, securities companies are not immune to competition. In response to the artificial fixed commission rates structure, natural market forces led securities companies to compete on the basis of other considerations, such as loss compensation guarantees.<sup>49</sup> Hence, in economic terms, the guarantees provided by securities companies to favored clients can be viewed as quantity discounts or rebates on commissions.<sup>50</sup> Viewed in this light, guarantees resemble the practice of "give-ups."<sup>51</sup>

48. James Sterngold, *Market Place: Was Japan's Trading Rigged? A Quiet Yes*, N.Y. TIMES, Jan. 20, 1992, at D1.

49. Joseph A. Grundfest, *Shoken Fushoji Tettei Kaimei o*, [Scandals and Mysteries: A U.S. Perspective on Recent Developments in Japan's Securities Markets], NIHON KEIZAI SHIMBUN, Jul. 23, 1991, at 27.

50. In October 1991, the Ministry of Finance launched a special investigation concerning allegations that Yamaichi Securities and Kankaku Securities paid their major clients kickbacks that amounted to rebating brokerage commissions. The alleged kickbacks took place when Yamaichi Securities' Kurashiki branch and Kankaku Securities' Okayama branch sold favored clients newly issued stocks and convertible bonds certain to rise in value, and later bought them back at higher prices. One client was reportedly rebated 41% of his commissions by Yamaichi Securities in its successful attempt to lure his ¥10 billion (\$76.92 million) account away from a competitor. The alleged rebates would be in violation of SEL Article 131, which obliges securities companies to charge only stock transaction commissions fixed by the stock exchanges. *Commission Kickbacks at Yamaichi Securities?*, NIHON KEIZAI SHIMBUN, Oct. 14, 1991, at 1; *Yamaichi Securities: Records of Repayments to Investors*, NIHON KEIZAI SHIMBUN, Oct. 15, 1991, at 15; *Kankaku Securities Under Suspicion for Commission Kickbacks*, NIHON KEIZAI SHIMBUN, Oct. 16, 1991, at 7.

51. "Give-ups" refer to the practice in the United States whereby a customer would bargain with the broker to give up a portion of the fixed commission to a third-party, who would in return provide the institution with some form of services (e.g., research or computer facilities). See generally LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 689-91 (1988). This

With commissions fixed at a high level, dealing in the Japanese market is expensive and inefficient for the customer. But, for the securities company, it produces enormous profits.<sup>52</sup> Fixed commission rates accounted for an average of 76.9% (53.1% brokerage commissions and 23.8% other commissions) of the operating income of securities companies in the fiscal year ended March 1990.<sup>53</sup> It was this protected system which helped to bloat the securities companies' brokerage profits, giving them the sort of financial clout and incentive to bankroll abuses like loss compensation.

### 3. *Eigyo Tokkin*

*Eigyo tokkin* funds were undeniably one of the main factors behind the compensation scandal.<sup>54</sup> "*Eigyo Tokkin*" refers to the common, yet illicit practice whereby investors allow securities companies complete discretion<sup>55</sup> in investing their funds. In exchange, investors sometimes sought guaranteed returns or compensation of potential losses. One way investors accomplished this was by having their securities company fill in a blank order form with the necessary specific information such as the number of shares, transaction price, and previous day's date in order to make it appear as though the securities company was merely following the investor's specific instructions.<sup>56</sup>

In Japan, a corporation investing in the capital markets is normally required to average the prices of securities it acquires with identical securities it already holds.<sup>57</sup> Due to the vast mutual shareholdings of most major Japanese corporations in affiliates and group companies, often acquired at close to par value, this resulted in artificially large capital gains and subsequent taxes on speculative investments in securities of companies with which the investor had an ongoing relationship. Not surprisingly, this rule increased the effec-

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was a common practice prior to the abolition of fixed brokerage commissions in 1975 and some courts even suggested that institutional investors had a fiduciary duty to seek such accommodations. See, e.g., *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1972). A more recent, but similar practice sanctioned under Section 28(e) of the Exchange Act is that of "soft dollars." Soft dollars refers to the practice whereby a client pays a brokerage firm for its services, such as research, through commission revenue, rather than through direct payments. See SEC, [Release No. 34-23170], 17 C.F.R. Part 241, 51 Fed. Reg. 16004 (1986).

52. Under the fixed commission rates regime, loss compensation was an effective means of boosting commission revenue and made perfect economic sense. Despite the enormity of the amounts involved, the ratio of total loss compensation payments to total commission revenue was less than 3.7% in the period from 1987 to 1991 (See *infra* Appendix D).

53. JAPAN INSTITUTE, *supra* note 27, at 170.

54. One hundred thirty-eight of the 231 reported cases of loss compensation up to March 1990 involved *tokkin* funds. Nihon Keizai Shimbun, Sept. 27, 1991, at 1.

55. Interestingly, however, "*eigyo tokkin*" is not a proper term since there is no legal basis for the existence of such an investment vehicle. The Specified Money Trust (*Tokutei Kinsen Shintaku*), or "*tokkin*" for short, is a special tax-advantaged trust account. As its English name suggests, the trustor gives *specific instructions* to the trustee concerning the methods of employment of the entrusted property. Technically, either investors or investment advisor companies can manage *tokkin* funds, with trust banks acting as custodians.

56. See Kawamoto, *Sonshitsu Honten Boshi o Hoteki ni Do Kangaeru ka* [How to Legally Prevent Loss Compensation], EKONOMISUTO, Aug. 27, 1991, at 19.

57. See *supra* note 5.

tive cost of cross-shareholdings and virtually prohibited corporations from speculating in such shares. This began to change, however, with the introduction of *tokkin* funds in 1975. By employing outside managers to establish *tokkin* funds, corporations could invest in securities without having to average the book valuation of assets in trust with their other securities holdings (*boka bunri*), and thereby, avoided the collateral adverse tax consequences.<sup>58</sup> By the mid-1980s more and more corporations moved to establish *tokkin* accounts.

*Eigyo tokkin* accounts are a source of contention for the Ministry of Finance, which has, at least technically, banned securities companies from operating discretionary accounts since the mid-1960s.<sup>59</sup> In practice, however, the Ministry's stance against such discretionary accounts was largely eased and such violations overlooked amid the bull market of the 1980s and the general atmosphere of deregulation. In late 1989, the Ministry ordered the closure of such *eigyo tokkin* accounts by the end of 1990.<sup>60</sup> However, for the period from December 1989 to March 1991 the total number of *eigyo tokkin* accounts decreased by less than twenty percent to 18,122 accounts.<sup>61</sup> This may be due in part to the precipitous drop in the Japanese stock market since 1990<sup>62</sup>, which would have caused securities companies to lose massive amounts of money had they closed their *eigyo tokkin* accounts.

These statistics tend to negate the common belief that loss compensation was peculiar to *eigyo tokkin* accounts and that the mass termination of those accounts in a depressed market was the sole cause of loss compensation. Indeed, evidence of numerous payments to clients who had suffered no losses would seem to suggest the prior existence of specific yield guarantees in direct violation of SEL Article 50.<sup>63</sup> Moreover, as mentioned above, more than forty percent of the reported incidents of compensation were related to general accounts, not *eigyo tokkin* accounts, which tends to further support the argument that guarantees did in fact occur prior to investment transactions. *Eigyo tokkin* accounts were a major factor in the scandal, but played a different role than believed.

#### 4. Japanese Business Organizations

What value did the customers who received guarantees provide to the securities companies to make it worth their while to provide this benefit? To answer this question, it is necessary to understand the relationship between the securities companies and their clients. Corporations and securities com-

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58. H. Hayashi, SHINTAKU NO JIDAI [THE TRUST ERA] 129-32 (1992).

59. SEL, *supra* note 3, art. 127. The MOF possesses broad powers to interpret the SEL through ordinances and general policy-making decisions.

60. *Son Shitsu hoten* [Loss Compensation], NIHON KEIZAI SHIMBUN, Sept. 27, 1991, at 5.

61. NIHON KEIZAI SHIMBUN, Sept. 6, 1991, at 5.

62. Having reached a high of 38,915.87 in late 1989, the Nikkei 225 stock average has dropped to around 15,500 at the time of this writing.

63. See *supra* note 5.

panies have developed increasingly strong relations over the years. Their roles in the capital markets are multiple: corporations are both issuers and investors, while securities companies are underwriters, brokers, dealers, and sometimes, as in the case of *eigyo tokkin* accounts, fund managers. Given the complex natures of these roles, any particular transaction is viewed as a mere phase in an ongoing relationship. In other words, spot transactions seldom occur in these situations.

Most listed companies in Japan hold shares of affiliated or group companies. These systems of mutual shareholding are referred to as stable-shareholding (*antei kabu*) or cross-shareholding (*mochi ai*) and are an often mentioned characteristic of *keiretsu*, or industrial groups.<sup>64</sup> This linkage of affiliated companies through ownership of each others' shares has a profound impact on the overall structure of Japan's capital markets. The most noticeable effect of this system is the restricted availability of stock for trading.<sup>65</sup> Since the percentage of group-owned shares is kept relatively constant, a significant portion of both outstanding and newly issued shares is removed from the trading market, and the number of floating shares (*fudo kabu*) which can be freely traded on the market is substantially reduced.<sup>66</sup>

The Tokyo Stock Exchange ("TSE") vies with the New York Stock Exchange ("NYSE") for status as the world's largest capital market in terms of total trading volume and aggregate market capitalization.<sup>67</sup> World's largest, however, does not necessarily mean world's most efficient. The impact of a greatly reduced amount of stock available for active trading is two fold: (1) the Japanese stock market is relatively more susceptible to market manipulation, and (2) volatility in the market is amplified.<sup>68</sup>

The Big Four's dominant position in the market, combined with a limited supply of actively traded shares, is a perfect recipe for market manipulation. Large market participants such as the Big Four and major institutional investors can quite easily influence the prices of particular issues. The foreign press would even go so far as to credit the Big Four with being able to control the entire market,<sup>69</sup> but that is an overstatement as shown by their inability to

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64. See generally ROBERT J. BALLON & IWAO TOMITA, *supra* note 33, at 114.

65. According to recent estimates, stable- and cross-shareholdings account for 60% to 70% of the total outstanding shares on the Tokyo Stock Exchange. *Patterns and Implications of Japanese Stockholding*, *supra* note 30, at 7. Similarly, it was estimated that individual investors' shareholdings stood at only 23.1% of the total shares listed on Japanese stock exchanges in March 1991. *Market Structure Works Against Small Investor*, REP. FROM JAPAN, July 25, 1991.

66. See, e.g., 2 KAISHA SHIKIHO 566, 639, 853 (Mar. 25, 1992) (the percentage of actively traded stock of Toyota Motors, Sony, and Mitsubishi Bank as of September 1991 was 7.9%, 19.6%, and 7.4%, respectively).

67. Yas Idea, *Foreign Brokerages in Japan in Life and Death Scramble: Global Links Among Keys to Best Profits*, NIKKEI WEEKLY, Dec. 21, 1991, at 1.

68. *Patterns and Implications of Japanese Stockholding*, *supra* note 30, at 7.

69. See, eg., *Foreign "Mice" Roar at the TSE: Overseas Houses Gain Advantage over Local Firms*, COMLINE NEWS SERVICE, July 1, 1992, available in LEXIS, Nexis Library, FIN File.

prevent a steep decline in Japanese stock prices, which currently stand about 60.2% below their prior peaks.<sup>70</sup>

A thin trading market also helps to exaggerate price fluctuations. The TSE experienced rising share prices throughout the 1980s. As share prices rose, corporations issued new securities to raise cheap capital which they often turned around and invested in the market.<sup>71</sup>

The effect of their actions was to push prices even higher. However, once the bubble burst in 1990, the pendulum swung to the opposite extreme. Corporate investors' portfolios were saddled with massive paper losses and devastated by falling share prices. This in turn, reduced their net worth and sent their stock prices lower.

Corporate attitudes toward financial management took a drastic turn in the mid-1980s.<sup>72</sup> Prior to this, investments in stock were restricted to building and maintaining cross-shareholdings in affiliated or group companies. However, during this period, companies began to manage their financial assets more aggressively<sup>73</sup> due in part to poor results in their main line of business. In 1987, a number of companies were able to post strong annual profits despite operating losses thanks to this new-found religion.<sup>74</sup> Furthermore, when operating results later improved, many firms poured even more resources into financial investments.<sup>75</sup>

One thing remained constant however: corporate managements' aversion to risk. In this environment, a tacit understanding arose. Financially unsophisticated corporations increasingly gave securities companies complete discretion in investing their funds and were often guaranteed a "target" return, or compensation against losses. The corporations mistakenly relied on the securities companies' guarantees and viewed their investments as "risk-free." Securities companies for their part were overly aggressive in their at-

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70. See *supra* note 62.

71. During the latter half of the 1980s, many corporations were able to float convertible bonds and bonds with warrants, often at zero or even negative cost. *The Art of Not Learning from Experience*, *ECONOMIST*, Mar. 2, 1991, at 73-74. This ability to raise capital at low or no cost caused corporations to rely increasingly on direct financing. In the three years up to 1990, corporate equity financing totaled about ¥60 trillion (\$461.54 billion). *Market Structure Works Against Small Investor*, *REP. FROM JAPAN*, July 25, 1991.

72. See generally Tatsuro Tamura, *Changes in Corporate Fund Raising and Management* (pt. 2), 29 *FAIR FACT SERIES: JAPAN'S FINANCIAL MARKETS*, FOUND. FOR ADVANCEMENT INFO. AND RES., JAPAN (1987).

73. The trend of increased emphasis on financial management in Japan is often referred to as *zaitech*.

74. For example, in the fiscal year ended March 1987, Nissan Motors posted a net income of ¥46.6 billion (\$358.46 million), despite an operating loss of ¥8.4 billion (\$64.62 million), thanks largely to sales of investment securities and trading profits. 3 *KAISHA SHIKIHO* 621 (June 25, 1988). More recently, however, many of the corporations which aggressively employed *zaitech* such as Hanwa Co. and Sanrio have been hard hit by the stock market crash. *Tobashi Contract*, *NIHON KEIZAI SHIMBUN*, Mar. 27, 1992, at 17.

75. Securities companies played a key role in instigating and perpetuating this new trend. They actively solicited corporations to raise additional funds which were subsequently entrusted to them in the form of *eigyo tokkin* accounts.

tempts to increase underwriting and brokerage commissions. Moreover, they underestimated the probability that they would have to make good on their promises and overestimated their ability to do so.

##### 5. Ministry of Finance

The loss compensation scandal created a crisis in the public's confidence in the integrity and ability of the Ministry.<sup>76</sup> Only with an awareness of the close relationship between the Ministry of Finance and the Big Four is it possible to understand how these companies were able to compensate favored clients.

The Ministry of Finance centralizes regulation of financial services much more than any single institution performing similar functions in the United States. If the United States were to attempt to create a similar institution with equal powers and responsibilities, it would need to combine several existing institutions including the Department of Treasury, the Office of Management and Budget, the Securities and Exchange Commission ("SEC"), and state banking and insurance regulatory agencies.

The Ministry of Finance is entrusted with three potentially conflicting roles in its relations with the securities industry: (1) development of capital markets; (2) government fund-raising; and (3) regulation of the markets.

The Ministry has actively carried out its first mandate of developing capital markets. In pursuing this goal, the Ministry appears to have adopted the view that a strong securities industry is both necessary and desirable. Following the stock market crash in the 1960s, the Ministry placed emphasis on ensuring sound growth of the securities industry by implementing a licensing system. Under this licensing system competition from new entrants into the industry is practically nonexistent,<sup>77</sup> the one exception being entry by foreign securities companies. Industry observers claim that no securities company is "permitted" to go bankrupt because, should that happen, the Ministry could be held responsible for granting it a license in the first place.<sup>78</sup> Faced with the threat of having to ultimately bail out bankrupt securities companies, the Ministry is protective of the companies it oversees.<sup>79</sup> Indeed, the Ministry

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76. According to a poll conducted by Japan's leading financial newspaper, 48.4% of the respondents felt that the Ministry was primarily to blame for the scandal. *NIHON KEIZAI SHIMBUN*, Oct. 11, 1991, at 7.

77. The rules for the establishment of a securities company are governed by SEL Article 31 and administrative guidance from the Ministry of Finance. Due to the extremely vague criterion, new securities companies have had difficulty qualifying for licenses. Critics of the system claim that the Ministry deliberately discourages applicants so as to avoid new competition. *Reform Initiatives Will Aim to Clarify Brokerage Licensing Rules*, *INT'L SEC. REG. REP.*, Nov. 18, 1991. Further, the Ministry even restricts the number of securities companies allowed to set up in any one region.

78. *MOF's Punishment Does Not Fit the Crime*, *NIKKEI WEEKLY*, July 20, 1991, at 6.

79. The Ministry of Finance has established capital adequacy rules for securities companies which require them to maintain sufficient liquid capital to absorb their financial risks. Recently, however, the Ministry relaxed these rules by allowing securities companies to include subordinated loans in their liquid capital and to regard half of their highly liquid securities port-

places priority on protecting securities companies and has never published details of any administrative action taken against a securities company.

The Ministry normally takes a hands-off approach in regards to trading trends in the capital markets. Nevertheless, it has been known to directly and actively intervene in times of distress. In the wake of "Black Monday" in October of 1987, the Ministry changed the accounting formula for *tokkin* funds in an attempt to lessen the possibility that trading losses would be reported, thereby preempting the danger of further sell-offs. Later, during 1990, the Ministry attempted to restrict equity financing to prevent an over-supply of stock on the market. It similarly arrested selling pressure by allowing investment trust companies to extend the lives of funds, some which have fallen sixty to seventy percent below their par value due to heavy losses in underlying stock investments.<sup>80</sup> All of these policies were aimed at supporting the market and preventing a free-fall in stock prices.

Secondly, the Ministry has traditionally played the role of fundraiser for the government. This places the Ministry in a position to use financial regulation to support the fiscal program of the central government. Consequently, a close relationship exists between general budget issues and financial regulation. According to one source, "[a]s the issuer of government bonds, the Ministry wants to keep interest rates low, which works to push up stock prices."<sup>81</sup> It also wants to maximize the sale price of government-owned stocks of privatized corporations, such as Nippon Telegraph and Telephone ("NTT"), Japan Rail, and Japan Tobacco. The desire to sell such securities at the highest price possible provides an added incentive to support the market. Moreover, it may also create a disincentive to actively prosecute manipulative practices in the securities industry: practices which often work to its advantage.

The Ministry's third role, and a role it has often neglected to date, is that of overseeing the capital markets. Japanese financial regulation is defined and enforced by a process of administrative fiat rather than by a set of explicit

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folios, primarily listed shares, as capital. [*Hard Times for Financial System*], NIHON KEIZAI SHIMBUN, Sept. 26, 1992 at 1.

80. Robert Thomson, *Investors Fall Foul of Market Turbulence*, FIN. TIMES, Jan. 29, 1992, at 27; NIHON KEIZAI SHIMBUN, Mar. 13, 1992, at 7. Most recently, the Ministry announced emergency reforms to support the stock market and prevent a financial meltdown. The main provisions of the emergency measures include: (1) exercising restraint over banks to prevent them from selling their stockholdings to improve their balance sheets and to avert a further fall on the ailing stock market; (2) a temporary freeze on the ceiling of the payout ratio at 40% of earnings to encourage companies not to sell more stock than necessary to meet their dividend payments; (3) permission for financial institutions to postpone a write-off of valuation losses on stock holdings until the fiscal year-end in order to prevent them from dumping their stockholdings ahead of the September 30 deadline for the closing of their mid-term accounts; and (4) measures to help financial institutions ease the burden of property held as collateral against bad loans by establishing a scheme in the private sector to help liquidate such properties. *Harried Finance Ministry Moves to Staunch Market Bloodlettings*, JAPAN TIMES, Aug. 31-Sept. 6, 1992, at 1, 5.

81. *MOF's Punishment Does Not Fit the Crime*, *supra* note 78, at 6.

rules.<sup>82</sup> The statutory law regarding securities regulation in Japan merely establishes the formal framework. The inner workings of this regulatory scheme remain vague, since court precedents relating to securities regulation are few and far between. Against this background, the Ministry is able to issue formal and informal administrative interpretations of the relevant statutes based on its supervisory function over the securities markets and its participants. The Ministry issues its interpretations in the form of directives, guidelines, and recommendations.<sup>83</sup> As explained earlier, such interpretations are not in and of themselves laws. However, ignoring or violating them can lead to administrative sanctions and other adverse consequences.<sup>84</sup> To further complicate matters, these interpretations are often vague and not recorded in writing to maximize Ministry discretion and control, while minimizing the Ministry's potential responsibility.<sup>85</sup>

Japan's securities markets are regulated by the Securities Bureau of the Ministry of Finance.<sup>86</sup> In general, Ministry officials jealously guard their own interests, while simultaneously protecting the interests of the industries and companies they supervise. The Securities Bureau is no exception to this rule and actively lobbies for the securities industry.<sup>87</sup> Herein lies one of the major structural problems of the Ministry: the partisan nature of its different bureaus.

The Ministry's policies provided fertile ground for the formation of the Big Four's oligopoly. The Securities Bureau with a staff of 130 officials, as compared to the SEC's staff of 2,200,<sup>88</sup> is dependent on the cooperation of the securities companies themselves. In particular, Securities Bureau officials cannot afford to lose the cooperation of the Big Four. Traditionally, consulting the Big Four was all the Ministry needed to do to create a consensus before implementing new measures. The relationship is symbiotic, however, and securities companies recognize that it is in their own best interests to maintain good relations with the Ministry. These relations are considered so important that many of the liaisons at securities companies pay daily visits to

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82. See generally John O. Haley, *Administrative Guidance Versus Formal Regulation: Resolving the Paradox of Industrial Policy*, in LAW AND TRADE ISSUES OF THE JAPANESE ECONOMY 107-17 (Gary R. Saxonhouse & Kozo Yamamura, eds., 1986).

83. See *supra* note 59.

84. Although the Securities Bureau has the authority to sue for injunctions against unlawful acts pursuant to SEL Article 187, such authority has never been invoked.

85. Absent an administrative mandate, there is no recourse in the courts to appeal administrative guidance. Michael K. Young, *Judicial Review of Administrative Guidance: Governmentally Encouraged Consensual Dispute Resolution in Japan*, 84 COLUM. L. REV. 923, 956 (1984).

86. The concept of independent administrative organizations was rejected by Japan many years ago. Japan's Securities and Exchange Commission, which was patterned after its counterpart in the United States, was short-lived. Founded in 1948, it was abolished in 1952 once the allied occupation ended. Its functions were subsequently absorbed by the Ministry of Finance. Makoto Yazawa, *A Synopsis of Securities Regulation in Japan*, in JAPANESE SECURITIES REGULATION, *supra* note 18, at 25.

87. For a general discussion on public choice theory and capture hypothesis, see SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 21-23 (1981).

88. Stokes, *As the World Trades*, 31 NAT'L J. 2023, 2025 (1991).

the Ministry just to keep in close and constant contact.<sup>89</sup> In short, the whole system centers on a network of carefully cultivated relationships among Ministry of Finance officials and the financial institutions they oversee.

Various industry practices serve to further strengthen these relationships. For example, after retiring at age fifty-five, Ministry officials typically receive choice positions in the securities industries, a practice known in Japan as *amakudari*. This practice is wide-spread and more than 280 Ministry of Finance officials have retired to industry jobs in the past five years alone.<sup>90</sup> Some of the top jobs landed by former high ranking officials include president of the TSE, head of the Japan Securities Dealers Association ("JSDA"), and high management positions at most of the major securities companies.<sup>91</sup> As a result of this practice, Ministry officials tend to align their interests with those of the securities industry, their future employers.<sup>92</sup> Due to the strength and influence of the Big Four, and Nomura Securities in particular, the Ministry may have found it difficult to effectively exercise its administrative policy over the securities industry.

A further reason put forth for the Ministry's laxity in overseeing the securities industry was the large political donations by securities companies to the ruling Liberal Democratic Party ("LDP"). The securities industry is one of the three largest benefactors of the party and has reportedly donated more than ¥3.5 billion (\$26.92 million) to the LDP over the past ten years.<sup>93</sup>

In summary, the main reason securities companies were willing to provide compensation of losses and guarantees was in order to obtain and retain underwriting, brokerage, and fund management business. In their efforts to procure such business from corporate issuers-investors, securities companies guaranteed yields and compensation of losses, and subsidized the costs of such benefits with their monopoly profits in brokerage and underwriting commissions. Lax regulation by the Ministry allows this practice to continue unhindered. These facts are, by now, well recognized, at least among most experts and industry observers. Unfortunately, however, far less attention has been given to the collateral problems which arose from the practice of guaranteeing return or principal, most notably the nondisclosure of the significant risks involved.

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89. In view of the Ministry's close contact with the securities industry, it is extremely difficult to believe that securities companies acted without the Ministry's knowledge, or tacit approval, in compensating select clients. See, e.g., Sato, *Okurasho wa Shitteita* [*The Ministry of Finance Knew*], ASAHI SHIMBUN WEEKLY AERA, July 23, 1991, at 10-11.

90. KYODO NEWS AGENCY, July 5, 1991, available in LEXIS, Nexis Library, JEN File.

91. See Otsuka Masaji, *Okurasho no "Shippai"* [*The Ministry of Finance's Failure*], NIKKEI FAINANSHARU 92 87-92 (1991).

92. See generally PHILLIPS & ZECHER, *supra* note 87.

93. REP. FROM JAPAN, Aug. 12, 1991. Funds provided indirectly through use of "political stocks" must also be added to these figures. See *supra* note 43. Understandably, however, no precise data on the amount of such "contributions" is available.

### C. Why Guarantee?

At first blush, the sheer magnitude of the risks and costs involved in the securities companies' actions suggests that guarantees are inefficient. Moreover, the cost of guarantees is unknown in advance. In one sense, a guarantee of principal or return is similar to a securities company writing a put option. The risk-exposure of guarantees is heavily influenced by market trends. As long as the overall market continues to climb, the burden of these guarantees to the securities companies is minimal. On the other hand, if the market begins to stagnate, this burden increases in proportion to the guarantee. If the market suffers a steep decline, as it inevitably did, the securities companies must make good on their guarantees. From an investor's standpoint, guarantees resemble bank deposits in two important aspects: principal is guaranteed and returns are fixed. Indeed, faced with the highly risky nature of securities investments in Japan, this type of "investment vehicle" is exactly what investors demanded.<sup>94</sup>

Notwithstanding the various incentives for non-price competition among securities companies, the question still remains as to why securities companies chose to employ guarantees in particular. Three major factors combined to make guarantees the *modus operandi* most favored by securities companies: (1) the securities companies' emphasis on *noruma eigyo* (sales quotas),<sup>95</sup> (2) fierce inter-industry competition between the securities industry and banking industries; and (3) the inefficiencies associated with the Ministry's over-protection of securities companies and the securities industry in general.

#### 1. *Noruma Eigyo*.

The relatively strong bargaining position of risk-averse investors enabled them to demand the creation of an investment vehicle similar to bank deposits. *Noruma eigyo* creates a vicious cycle. Merely attaining the monthly quota is insufficient. Once a salesman attains his monthly quota he is expected to surpass it in the following month. Although individual salesmen feel the pressure of sales quotas, no one feels it more than the branch manager. In most cases of compensation, before a salesman guaranteed a client's losses, he got approval from his branch manager. It was not within a salesman's discretion to decide on the most efficient method of soliciting business. The branch manager, while reluctant to guarantee a client's portfolio, is nonetheless willing to do so in order to maximize the commission income at his branch. Indeed, for purposes of self-preservation, the branch manager has little choice to do otherwise. The successful salesman-turned-branch-manager is faced with a dilemma. Thanks to his prior record of successfully boosting commission income, he has been promoted and has gained a reputation within the company for accomplishing the impossible. In addition, he

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94. See *infra* part IV.C.2.

95. See *supra* note 39.

knows that he has the opportunity to become a director if he is able to perpetuate his success. The flip side of this, however, is that he is faced with the increasingly difficult task of perpetuating his successful track record.<sup>96</sup>

Viewed in this light, it is not difficult to understand a branch manager's relative preference for increased commission income over any marginal increase in risk associated with guarantees. After all, commission income is the *sole* criterion for success or failure at a securities company. And while the benefit of increased commission income is personal to the branch manager, collateral risks accrue to the securities company in general. The importance which securities companies place on intra-industry rankings (e.g., market share of TSE trading volume and underwriting) cannot be overemphasized. Thus, upper management condoned this practice in order to maximize brokerage and underwriting commissions.

## 2. *Competition with the Banking Industry*

Another important reason why securities companies guaranteed principal and returns for investors was in order to remain competitive with banks. Securities companies are not unique in providing financial services. In the past, investment products offered by banks were regulated with respect to interest rates. As a result, inter-industry competition was minimal. More recently, however, many of these products have been deregulated and are now able to offer higher interest rates in order to attract customer funds. Consequently, securities companies were compelled to offer similar competitive terms to prime customers. The loss compensation scandal underscores the on-going tug-of-war between the securities and banking industries over who will rule the financial world. The future for each industry is becoming increasingly blurred as the barrier separating the two slowly crumbles.<sup>97</sup>

## 3. *Moral Hazard Problem*

The Ministry plays an active role in protecting securities companies and the securities industry in general. Protection is afforded in a variety of ways, such as branch restrictions, rigid entry barriers under the Ministry's licensing system, the fixed commission rate structure, and continued separation of various types of financial institutions.<sup>98</sup> For example, in 1965, the Bank of Japan

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96. The situation is similar for star salesmen. A star salesman at one of the major securities companies was derailed from the fast track after his corporate client demanded that the securities company make good on his alleged yield guarantees. Management reprimanded the salesman for his "unauthorized" actions and transferred him to an undesirable position. It is extremely difficult to believe that he acted independently, however, and it is more likely that his superiors expressly or tacitly approved his actions.

97. See generally Richard C. Hanson, *Financial System Reform, Gimmicks*, JAPAN FIN. REP., Vol. 9, No. 10, Mar. 16, 1992, at 2, 8.

98. See, e.g., Tokusuke Kitagawa, *International Securities Transactions*, in JAPANESE SECURITIES REGULATION, *supra* note 18, at 69, 76.

saved Yamaichi Securities from bankruptcy with an unsecured loan of ¥28 billion (\$215.39 million).<sup>99</sup>

This policy of protecting securities companies is not without serious repercussions. The major consequence of the policy is that it diminishes a securities company's incentive to deal efficiently with risk, and spares the industry from the discipline imposed by such risk. To the extent management knows the Ministry will protect securities companies in the event risks prove too great, there is less incentive for management to be concerned with the risk of bankruptcy. This is the so-called "moral hazard" problem. Accordingly, none of the securities companies have established serious risk management systems. With market penalties for assuming more risk minimized, the incentive is for management to assume a higher risk profile than normal.<sup>100</sup>

In fact, this is exactly what happened in the loss compensation scandal. One of the immediate results of the revised law is to protect securities companies by allowing them to avoid full payment of compensation.<sup>101</sup> This would relieve many securities companies of their considerable obligations to make loss compensation payments and guarantee yield payments on their *eigyo tok-kin* accounts. Because the Ministry has handled most securities company failures in a way that protects virtually all market participants,<sup>102</sup> the operation of market forces which would otherwise constrain such risk-taking is inadequate. In sum, permitting securities companies to avoid the full cost of their activities creates incentives for excessive risk-taking.

### III.

#### REVISING THE SECURITIES AND EXCHANGE LAW

##### A. Changes under the 1991 Amendments

On October 3, 1991, the Diet passed an administration bill, revising the SEL in an effort to eliminate compensation schemes it deemed unfair.<sup>103</sup> The amendment became effective on January 1, 1992, and punishes both securities companies which compensate clients for investment losses and the recipients of such payments.<sup>104</sup> The revised law makes investment loss payback a crim-

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99. JAPAN INSTITUTE, *supra* note 27, at 18; see also ALBERT J. ALLETZHAUSER, THE HOUSE OF NOMURA 160 (1990).

100. For an interesting comparison of the moral hazard problem in the United States banking industry, see U.S. TREASURY DEPARTMENT, MODERNIZING THE FINANCIAL SYSTEM (1991), at 112.

101. Ironically, some securities companies were reported to have asked their clients to bring suit for losses made through *tobashi* transactions following the SEL amendment. This would enable their clients to legally receive "compensation" in settlement of these "disputes." *Some Say Stock Brokerages Imploring Client to Sue for "Tobashi" Losses*, KYODO NEWS SERVICE, Feb. 26, 1992, available in LEXIS, Nexis Library, JEN File.

102. The Ministry's protection of securities companies can be analogized to a company's protection of its star salesman. See *supra* note 96. When the Ministry bails out securities companies in times of trouble, it is encouraging the companies to assume extra risks.

103. *Amendments to the Securities and Exchange Law*, FIN. REG. REP., October 1991.

104. SEL, *supra* note 3, art. 50-2.

inal offense and carries penalties of up to one year in prison or a fine of up to ¥1,000,000 (\$7,692) for securities companies which agree to pay compensation for investment losses.<sup>105</sup> Clients who demand such compensation will be subject to up to six months in prison or a fine of up to ¥500,000 (\$3,846).<sup>106</sup> Under the revised law, any money paid to cover investment losses will be confiscated.<sup>107</sup> In addition, the amendment also bans discretionary securities accounts that allow securities companies to make investment decisions on behalf of clients.<sup>108</sup>

### B. Shortcomings of the Amendments

Despite the seemingly explicit nature of the amendments, potential problems still exist. First and foremost, the new legislation contains no clear definition of loss compensation. Instead, the Ministry will follow guidelines issued by the JSDA to determine which transactions amount to illegal payback. According to a September 10, 1991 draft prepared in cooperation with the governing board of the TSE, the JSDA guidelines would:<sup>109</sup>

[1] limit the number and the value of new shares assigned to any single investor [as well as the number of times per year a securities company will be allowed to sell such shares to the investor] (allotments over this limit would be considered a payback); [2] force dealers to trade unlisted bonds and stocks in line with prices for similar issues set by the JSDA with [limited] adjustments for variables such as maturity and coupon rate; [3] use Japan Bond Trading Co. quotations to set prices for trading of foreign currency-denominated warrants; and [4] limit the maximum legal price spread for listed bond prices to [two] percent.

Furthermore, according to the report, “[a]ny deals considered “abnormal” also would be subject to investigation.”<sup>110</sup> The JSDA only provided one example of abnormal activity, that of “a dealer selling a bond at the minimum price to a customer who had suffered a trading loss then immediately buying back the bond at the maximum price.”<sup>111</sup>

In theory, the lack of specificity is intended to “allow regulators to meet unforeseen situations.”<sup>112</sup> Unfortunately, this line of reasoning ignores the fact that a lack of specificity and transparency on the part of regulators helped bring about the loss compensation scandal in the first place. The draft guidelines further provide that securities company officials engaged in improper practices will be expelled from the industry for five years. Lastly, but perhaps the most problematic aspect of the JSDA’s guidelines is its opaque

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105. *Id.*, arts. 199, 202.

106. *Id.*, arts. 200, 202.

107. *Id.*, art. 200-2.

108. *Id.*, art. 127. See also *supra* text accompanying note 59.

109. Jon Choy, *Stock Trading Reforms Submitted, Further Changes Considered*, 35B JAPAN ECON. INST. REP. 2 (Sep. 20, 1991).

110. *Id.*

111. *Id.*

112. Choy, *supra* note 109, at 2.

distinction between illegal compensation and permissible payments to customers to settle "disputes."<sup>113</sup>

While the amended law will most likely be successful in preventing future compensation, it does not eliminate the economic incentives to continue the behavior which originally caused the loss compensation scandal. Unfortunately, the traditional Japanese government view of the world does not attempt to understand or accommodate economic incentives. Instead, regulation attempts to force economic actors to behave in a way contrary to their economic incentives. The recent revision of the SEL is very much in this tradition, relying as it does on regulatory prohibitions to correct an undesirable behavior while in fact the prohibitions only correct the result of the behavior.

The legislative solution addresses the consequences of the problem, not the causes. This solution does not come to grips with *why* securities companies compensated losses. As shown in Part II.B., the loss compensation scandal was merely symptomatic of the underlying structural problems of Japan's securities markets (i.e., market domination by the Big Four, fixed commission rates, corporate Japan's preoccupation with playing the dual role of issuer-investor, and lax or misguided regulation by the Ministry of Finance). In short, the economic incentives faced by the securities companies lie at the root of the loss compensation scandal.

Revising the law to prohibit compensation is like turning off a smoke alarm in order to prevent a fire: it alleviates that irritating noise just long enough for the securities market to burn down. If the amendment serves to quell public debate over the relevant issues and stifles further analysis of the underlying problems, amending the law may prove to be more harmful than beneficial. Indeed, in such case, it may have been better to have done nothing at all.

#### IV. REFORM PROPOSALS

Confronted with the structural problems that plague Japan's capital markets, what should be the objectives, instruments, and priorities of public policy? Undoubtedly, the overriding objective of reformers should be to maximize equity and efficiency in the capital markets. This section presents a number of proposals to achieve this objective. The primary goal in presenting these proposals is to stimulate further analysis and consideration of suitable long-term solutions to these problems.

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113. The Big Four reportedly paid more than ¥10 billion (\$76.92 million) in dispute settlements to major customers in the fiscal year ended March 31, 1991, and failed to report these payments to the Ministry and JSDA. See [JSDA Makes Final Plan to Submit to Government], YOMIURI SHIMBUN, Nov. 26, 1991, at 1. More recently, some securities companies have made large payments to settle disputes over failed *tobashi* transactions. See *infra* Appendix D.

### A. *Reforming the Regulators*

Based on the structure of the capital markets, reform of the Ministry must logically come before reform of the industry. Regulatory reform should be pursued not principally out of an effort to control securities companies, but rather to serve the collective interests of capital market participants. As described in Parts II.B. and II.C., three principal problems are related to the Ministry of Finance: (1) excessive discretionary power derived from ambiguous laws; (2) inherent conflicts of interest in connection with the various roles the Ministry plays; and (3) the moral hazard problem arising from the Ministry's overprotection of the securities industry.

#### 1. *Transparency in the Market*

A securities regulatory agency should be bound by explicit rules requiring it to take specified actions against violators of the securities laws. A good deal of the skepticism concerning the scandal resulted from the public's inability to understand it. A degree of ambiguity may be necessary and desirable to allow regulators to meet unforeseen circumstances. In principle, however, a high degree of transparency in terms of objective standards and publicly-disclosed rules is essential. The SEL should be overhauled, with any manifest ambiguity closely scrutinized and clarified by the Diet. In addition, Ministry guidance should be streamlined and codified.<sup>114</sup> Any remaining ambiguities should be interpreted by the judiciary and the outcome made public. In certain cases, sensitive matters may be more appropriately handled behind closed doors, however, this should be the exception rather than the norm.

#### 2. *Preempting Conflicts of Interest*

The inherent conflicts of interest within the Ministry must be reduced or eliminated. One radical solution proposed by some critics is to divide up the Ministry itself. Ministry critics such as Kenichi Ohmae, a partner in McKinsey & Co. in Japan, proposed breaking the Ministry into several unique offices according to function, such as taxation, budget planning, and financial market regulation, in order to eliminate conflicts of interest.<sup>115</sup>

Another alternative is to shift responsibility for market regulation to a newly created independent agency, a Japanese version of the SEC ("JSEC").<sup>116</sup> Proponents of a JSEC claim that an independent watchdog body, apart from the Finance Ministry, is needed to transform the capital

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114. The Ministry announced that out of its 450 instructions controlling the securities industry, it will abolish 140 of these instructions, convert 10 into law, and replace 60 with industry self-imposed rules and regulations. These changes were to take effect in April 1992. *Finance Ministry to Abolish 140 Guidelines for Securities Industry*, REP. FROM JAPAN, Feb. 6, 1992.

115. Kenichi Ohmae, *The Scandal Behind Japan's Financial Scandals*, WALL ST. J., Aug. 6, 1991, at A14.

116. Akiyoshi Horiuchi, *Shoken Shijo no Kosei Kakuritsu Okurasho de ha Fukano* [Establishing A Fair Securities Market: An Impossibility for the Ministry of Finance], EKONOMISUTO, Aug. 27, 1991, at 15-17.

markets into a healthy arena of financial activity.<sup>117</sup> On the other hand, opponents, such as the Ministry, maintain that the present administrative guidance has the inherent advantage of flexibility.<sup>118</sup> This argument completely ignores the fact that administrative guidance is itself one of the underlying problems.

In addition, opponents argue that a JSEC would be understaffed and underfunded, and therefore, unable to regulate the capital markets effectively.<sup>119</sup> This argument deserves some attention. A new agency's manpower and budget concerns are especially acute on account of the Ministry's control over the budget. Indeed, the Ministry would be in a perfect position to undermine any potential new rival. One way around this predicament might be to transfer market regulatory responsibility to an existing regulatory agency, such as the JFTC.<sup>120</sup> Alternatively, the JFTC could be partially funded by levying "user fees" on the securities industry.

The JFTC is an independent administrative body, but a majority of its members are former officials of either the Ministry of Finance or the Ministry of International Trade and Industry. The JFTC, long criticized as a toothless watchdog, has recently taken a much more aggressive stance in enforcing Japan's antitrust laws. In fact, in November 1991, the JFTC declared that securities companies violated antitrust regulations<sup>121</sup> by paying loss compensation to favored clients.<sup>122</sup> The significance of this JFTC action is considerable as it marked the first time the JFTC intervened in the financial industry.<sup>123</sup> The JFTC investigation which preceded the agencies' determination also established for the first time that payments not only attracted *eigyo tokkin* business, but also served to win underwriting deals.<sup>124</sup> Hence, the JFTC's action was seen as evidence that it intends to have a greater influence over the industry in the future. In order to strengthen the JFTC's power

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117. *Id.* at 16-17.

118. T. Itoh, *Nareai Shihonshugi he no Ketsubetsu [Departing from Collusive Capitalism]*, KINYU BUINESU, Sept. 1991, at 9.

119. *Id.*

120. In the United States, the Securities Act was originally administered by the Federal Trade Commission ("FTC") until the creation of the SEC. "Indeed, the creation of the SEC itself was a concession to the industry, which felt it would fare better under an agency whose energies were focused exclusively on capital markets and the securities industry—the industry had found the leading regulators at the FTC to be formidable and devoted regulators." James D. Cox et al., SECURITIES REGULATION 17, 21 (1991).

121. Article 19 of the Antimonopoly Law ("AML") prohibits the practice of receiving contracts by providing "unfair profits" to clients. The article does not provide for penalties, but the JFTC can refer repeat violators to public prosecutors for indictment. *Shiteki Dokusen no Kinshi oyobi Kosei Torihiki no Kakuho ni kansuru Horitsu [Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade]*, Act. No. 54, 1947 (as amended 1977) [hereinafter Antimonopoly Law].

122. Soon after the loss compensation scandal surfaced, JFTC officials expressed their intent to investigate, but noted that the Ministry of Finance had prime responsibility for the affair and that any JFTC action would come only after the Ministry ruled. Hiroshi Nakamae, *Only Giants May Survive Discount War*, NIKKEI WEEKLY, Nov. 30, 1991, at 4.

123. NIKKEI WEEKLY, Nov. 30, 1991, at 4.

124. *Slashing the Fabric*, ECONOMIST, Feb. 1, 1992, at 86.

within the government and over industry, a legislative council recently proposed raising the maximum penalty on corporate violators of the Antimonopoly Law to ¥100 million (\$7.69 million) from ¥5 million (\$38,461).<sup>125</sup> Increasing the JFTC's mandate would create a degree of synergy. Meanwhile, increasing its budget and status would go a long way toward giving this watchdog some teeth. The need for Japan's Antimonopoly Law to be consistently applied and rigorously enforced will increase as the Ministry continues to liberalize the financial industry; however, even with the recent financial reforms this issue is yet to be addressed.

In an attempt to regain control of the situation, the Ministry proposed its own plan in December 1991 to create a new "semi-independent" regulatory body to inspect securities companies and financial institutions.<sup>126</sup> The Ministry has prevailed, and its proposal to establish the Securities and Exchange Surveillance Commission ("SESC") was implemented in July 1992.<sup>127</sup> The SESC is empowered to search offices for evidence, ask public prosecutors or police to take action against violators, and recommend that the Finance Minister punish offenders.<sup>128</sup> The SESC is headed by three commissioners appointed by the Finance Minister with the approval of the Diet. The SESC has a staff of 202 people and is composed of two divisions. The two divisions are: (1) the Coordination & Inspection Division which will monitor the stock market and day-to-day activities, and (2) the Investigation Division which will investigate suspicious practices of brokers and clients.<sup>129</sup>

### 3. *Eliminating the Moral Hazard Problem*

The major securities companies' growth formula for the 1980s became a recipe for disaster in the 1990s. Since managers could succeed only by boosting commission income, they had little incentive to worry about the collateral risks. These securities companies soon found themselves with huge risk exposure in a declining market. Because they were backed by the Ministry, however, securities companies willingly assumed unduly high risk profiles. Thus, removing such protection in an effort to subject securities companies to increased market discipline is a laudable goal. It is a goal that may have to be achieved cautiously, however, since the Ministry's protectionist policy has to date given securities companies little incentive to adapt adequate risk management systems.<sup>130</sup>

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125. *Rise in Japan Antitrust Fine*, N.Y. TIMES, Mar. 13, 1992, at D2; See also DAILY REP. FOR EXECUTIVES, June 22, 1992.

126. See generally *Japan: Reforming the Market Monitoring System*, FIN. REG. REP., Jan. 20, 1992 for an overview of the first proposed structure of the SESC. This structure has been subsequently modified as indicated in the text of this paper.

127. *The Securities and Exchange Surveillance Commission*, FIN. REG. REP., July 1992.

128. *Id.*

129. *Id.* See also *Japan: Reforming the Market Monitoring System*, *supra* note 126.

130. Tsuchiya, *Belated Introduction of Risk Management*, NIHON KEIZAI SHIMBUN, Oct. 27, 1991, at 12.

Market risk, interest rate risk, and foreign exchange risk are the main risks to securities companies. These risks are increasing due to the deregulation and globalization of finance. Accordingly, removing such protection immediately will have serious adverse consequences. In order to minimize this harsh consequence, the Ministry should encourage securities companies to implement and strengthen such systems for risk management during a "phase-in period" of one to two years. After such time, however, the Ministry should definitively move away from its protectionist stance.

#### 4. *Staying the Course*

Finally, the government may decide to do nothing. To the government, this may be the most attractive and familiar alternative as compared to the radical proposals outlined in this paper. However, there is a risk to doing nothing. Without action, the underlying problems which triggered the loss compensation scandal will remain and will undoubtedly resurface at a later date, though in a different form. Japan can ill afford to be paralyzed in the face of these multifarious structural problems. Indeed, Japan would be well advised to study the history of the savings and loan (S&L) crisis in the United States.<sup>131</sup>

### B. *Reforming the Securities Industry*

Given the domination of the capital markets by the Big Four, the overriding objective must be to eliminate their oligopolistic control over the capital market. Obviously, however, the fact that they so utterly dominate the securities markets makes it difficult to remedy the situation.<sup>132</sup>

#### 1. *Liberalizing Commission Rates*

After numerous deliberations, the Securities and Exchange Council ("Council"),<sup>133</sup> although recommending deregulation of stock brokerage commissions for large-lot orders, suggested in a report submitted to the Finance Minister on January 28, 1992 that deregulation should be handled prudently.

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131. In the 1980s, the United States government took a lenient approach toward the mounting S&L problems. Weak institutions were kept alive through accounting tricks and other means that merely postponed their day of reckoning and magnified the clean-up costs. *A Savings and Loan-Style Crisis for Japan?*, JAPAN ECON. INST., Oct. 2, 1992, at 4-5.

132. When the Ministry of Finance penalized the Big Four by suspending their participation in government bond auctions for one month, several market analysts commented that the government ended up suffering also. They claimed that without the participation of the Big Four, the government may have had to offer a higher coupon rate in order to attract investors and raise capital. Quentin Hardy & Clay Chandler, *Four Japanese Broker Firms Disciplined*, WALL ST. J., Sept. 25, 1991, at C1, C14.

133. The Council was established pursuant to SEL Article 165 as an auxiliary body to the Ministry of Finance for the purpose of "investigating and deliberating important matters relating to the issuing and buying, selling or other transactions of securities."

dently.<sup>134</sup> The report, however, fails to set an explicit date for such liberalization. Moreover, the report does not advocate liberalization of smaller deals. Accordingly, it represents a further dilution of an earlier recommendation of phased-in liberalization of all brokerage commissions made by another governmental advisory panel, the Ad Hoc Commission on Administrative Reform.<sup>135</sup>

Not surprisingly, the securities industry opposes liberalization of commission rates and argues that it will encourage "excessive" competition among securities companies. Once liberalization appeared inevitable, however, the securities industry pressed to delay final decisions on timing. In light of the Council's recent report, most industry experts agree that any action is likely to be postponed until Autumn 1993 or later.<sup>136</sup> Aside from the issue of timing, heated debate is continuing as to the best method for liberalizing commission rates since various groups will be affected differently.<sup>137</sup> Foreign securities companies are particularly concerned with the form deregulation takes, since relatively speaking, a step-by-step approach beginning with large-lot fees would hit them the hardest due to their reliance on this segment of the market and lack of presence in the retail business.<sup>138</sup> At the same time, however, the ability of some of the more sophisticated foreign securities companies to profit from non-commission related areas such as stock-index arbitrage and trading in derivatives has helped them to post strong returns despite the prolonged market slump.<sup>139</sup>

In terms of total commission revenue, the Big Four will bear the brunt of deregulated large-lot fees, but are the best able to cope with such a move due to the diverse nature of their business and their solid client base which is comprised of both large and small investors. On the other hand, assuming that commission fees are eventually deregulated completely, many small securities companies which rely entirely on brokerage commissions will undoubtedly be forced into bankruptcy or merger, a result which flies in the face of traditional Japanese regulation. Therefore, the Council report suggests

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134. See *Caution Urged in Deregulating Stock Commissions*, JIJI PRESS TICKER SERVICE, March 3, 1992.

135. See *Securities and Banking Scandals May Rein in Ministry of Finance*, 1 THOMSON'S INT'L BANKING REG. 1 (Sep. 13, 1991).

136. Linda Seig, *Japan Brokerage Fee Deregulation Seen Delayed*, REUTERS, Jan. 29, 1992, available in LEXIS, Nexis Library, REUTERS File.

137. Commissions represented 34% of total income in fiscal 1990 for the Big Four. In contrast, commissions as a percentage of total income for securities companies capitalized at 3 billion or more were 49%, and 40% for foreign firms in Japan. The average for other securities companies exceeded 50%. Nihon Keizai Shimbun, Dec. 18, 1991, at 3.

138. For example, Prudential Securities (Japan) Ltd., a subsidiary of Prudential Securities Inc. of the United States, recently announced that it will curtail its Japanese equities business by the end of 1992. Thomas P. O'Toole, *Prudential Securities to Exit Japanese Equities Market*, NIKKEI WEEKLY, Nov. 23, 1992, at 18. See also *Prudential Denies Pullout*, JAPAN TIMES, Nov. 28, 1991, at 9.

139. Thomas P. O'Toole, *Tighter Market Seen for Foreign Brokerages*, NIKKEI WEEKLY, Nov. 9, 1992, at 16.

that consideration may be given later to retaining fixed commissions for small-lot trading if it becomes apparent that full-scale deregulation would raise commissions so much as to curb individual investor trading.<sup>140</sup>

Lastly, enthusiasm for reform also appears to be linked to the stock market's strength. If the market remains in its current slump,<sup>141</sup> liberalization will probably be postponed further. In light of the role the fixed commission rates structure played in the loss compensation scandal, this would be a truly paradoxical outcome.<sup>142</sup>

Assuming, *arguendo*, that commission rates are entirely deregulated, the probable outcome would be an industry shake-out. With recent trading volume and share prices considerably lower, competitive commission rates can only serve to depress further the profitability of brokerage operations.<sup>143</sup> Weaker securities companies will be faced with the decision to either merge or be acquired by a stronger competitor or affiliate bank.<sup>144</sup> Absent such a move, weaker firms will simply go bankrupt.<sup>145</sup> The result will be a significant consolidation of the securities industry.<sup>146</sup> Under a best case scenario, several efficient securities companies will emerge to challenge the existing oli-

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140. See Hiroshi Nakamae, *Move to End Fixed Commissions Worries Foreign Brokers*, NIKKEI WEEKLY, Nov. 30, 1991, at 15.

141. In 1991, the TSE's first section had a turnover of 91.7 billion shares with a daily average of 372.6 million shares. This was the worst year of trading since 1982, which had a turnover of 76.3 billion shares. NIKKEI WEEKLY, Jan. 11, 1992, at 1.

142. Ironically, commissions on stock futures and options trading in Japan were doubled on March 23, 1992. The move came amid charges that a surge in futures trading due to considerably lower commissions was causing excessive volatility in underlying cash markets. Commissions on cash stock trading worth ¥100 million (\$769,231) are nearly ten times higher than commissions on trading in futures of a like amount. [*Liberalization of Stock Trading Commissions*], NIHON KEIZAI SHIMBUN, Mar. 6, 1992, at 1.

143. Due to a sharp drop-off in commission revenue, Japan's top fourteen securities companies recognized total net losses of ¥107.9 billion (\$830 million) in the first half of fiscal 1993. Akira Ikeya, *Securities Firms Suffer Deeper Losses in 1st Half*, NIKKEI WEEKLY, Oct. 26, 1992, at 1, 20.

144. In one incident suggesting such a trend, Dai-Ichi Kangyo Bank ("DKB") recently announced the formulation of a rescue package to assist its securities affiliate, Kankaku Securities Co., avoid a financial crisis. DKB will reportedly purchase a mammoth computer center that Kankaku is constructing in Chiba Prefecture for ¥45 billion (\$346.2 million) and will absorb thirty to forty of Kankaku's system engineers into its computer subsidiary. This is the third other and most extensive example of a Japanese bank rescuing its securities affiliate. The two other examples to date are Daiwa Bank's rescue of Cosmo Securities and Sakura Bank's rescue of Yamatane Securities. [*Dai-Ichi Kangyo Bank Supports (Comes to Aid of) Kankaku Securities*], NIHON KEIZAI SHIMBUN, Sept. 26, 1992, at 1.

145. Medium-sized Mito Securities took over an affiliated securities company in January 1992, in a move industry observers said could herald a restructuring in the industry. Jonathan Sprague, *Shaky Tokyo Ponders Past*, REUTERS, Jan. 27, 1992, available in LEXIS, Nexis Library, REUTERS File.

146. At the same time, however, new firms may emerge to cater to specific market segments. For example, the first discount brokerage firm was licensed by the Ministry in January 1992. TIR Securities, a subsidiary of a large British discount broker, was expected to compete with "soft dollars" by providing free research to clients. [*Substantial Discount of Brokerage Will Be Offered*], NIHON KEIZAI SHIMBUN, Jan. 6, 1992, at 1. It was later disclosed that the Ministry of Finance issued the license on the condition that TIR promise not to provide free research to clients in proportion to the volume of their transactions, thereby, effectively prohibiting the use

gopoly.<sup>147</sup> Under a worst case scenario, however, the oligopolistic position of the Big Four will merely be strengthened. The result will likely depend on the method of deregulation, form of Ministry of Finance administrative guidance, and degree of enforcement of Japan's antitrust laws.

Liberalizing brokerage commissions alone is only part of the solution to reforming the securities industry. Allowing securities companies to continue maintaining high underwriting commissions through their cartel will exacerbate the situation.<sup>148</sup> The incentive to attract abnormally lucrative underwriting commissions could very well lead to the next securities scandal. In order to prevent this, the industry cartel should be abolished and underwriting commissions should be determined by competitive factors.

The existence of large monopoly profits derived from the fixed commission rates structure was clearly a major factor in the scandal. Only by deregulating fixed commissions will securities companies be encouraged to compete on price and performance, rather than by offering illegal guarantees to important customers. Once commission rates are liberalized, Japan's capital markets will follow the pattern set in New York and London. They will become slim-margined commodity businesses for the securities companies.<sup>149</sup> Abolishing the fixed commission rates structure entirely will help to alleviate some of the impetus behind the compensation scandal, but, contrary to the belief of some critics, it will not cure all of the underlying structural problems.

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of soft dollar discounts. [*MOF Does Not Allow Substantial Discount Firm to Compete with Soft Dollar*], NIHON KEIZAI SHIMBUN, Feb. 28, 1992, at 7.

147. In October 1991, the Big Four's market share of trading on the TSE fell to 13% as compared to a high of over 40% in the late 1980s. In contrast, the market share of the next twelve largest securities companies grew to more than 30% from 26% the previous month. This was due in large part to the temporary suspension of brokerage activities by the Big Four as punishment for their role in the loss compensation scandal. *Second Tier Companies' Share Exceeds Thirty Percent*, NIHON KEIZAI SHIMBUN, Oct. 22, 1991, at 3.

148. See *supra* note 47. According to a recent Ministry of Trade and Industry report, underwriting fees on (straight) corporate bonds are excessively high and are hampering corporate fund raising. Securities companies' underwriting commissions are 4.7 times higher than those in the United States. *MITI to Propose Liberalization of Bond Market*, REP. FROM JAPAN, Oct. 18, 1991.

149. Deregulation in stock markets abroad tended to lead to higher commissions for small retail investors while at the same time reducing fees for large transactions originated by major institutional investors. For example, in the five year period following the introduction of negotiated commission fees in New York in 1975, the rate rose 18% for investors on transactions involving 200 shares or less, while decreasing 50% for large-lot trades of 10,000 shares or more. Similarly, in London commission rates increased 40% for transactions of £2,000 or less, and fell 29% for transactions of £10,000 or more in the four year period following deregulation in 1986. Accordingly, the overall percentage of commission revenue decreased as such income fell and companies were compelled to diversify their operations. As a direct result of this upheaval, securities industries went through a phase of consolidation. [*The Security Industry After Liberalization in England and the United States: A Trend to Oligopolization*], NIHON KEIZAI SHIMBUN, Dec. 18, 1991, at 3.

## 2. Adopting Suitability Rules

Following the loss compensation scandal, all of the securities companies were long on the rhetoric of placing customers' needs before their own. Unfortunately, this is yet to happen. Instead of figuring out better ways to manage their business, too many securities company executives these days are taking comfort that the worst of the scandal seems to be over. They need to make good on their promise and think of meeting customers' needs.

The various Self-Regulatory Organizations (SROs) for the brokerage industry in the United States have adopted suitability rules as part of their authority to promote the just and equitable principles of the trade. For example, the "know your customer" rules of the New York Stock Exchange (NYSE) and American Stock Exchange (ASE) provide explicitly that the broker shall exercise "due diligence to learn the essential facts relative to every customer."<sup>150</sup> In contrast, brokers in Japan have no duty comparable to the suitability rules of the United States.<sup>151</sup> Thus, it is not surprising that brokers often pushed sales of securities which maximized commission revenues without regard to the varying risks involved for a given customer. Suitability based on a customer's financial status, tax status, investment objectives, and other reasonable related information must be taken into consideration by brokers in order to satisfy customers' needs. In order to do this, the securities industry (JSDA) should adopt "suitability" rules, and any disciplinary actions should be published to further stress the importance of such rules.

## 3. Independent Research

Independent analytical research is basically nonexistent among Japanese securities companies. What little that does exist is treated with skepticism and disdain.<sup>152</sup> The only serious independent research generated on Japanese issuers is usually done by foreign securities companies. Indeed, some investors complain that Japanese "research" is ninety percent advertisement and ten percent analysis. Only when securities research analysts gain recognition and independence will they be able to objectively analyze various issuers' securities based on each company's performance and future prospects, and thereby, provide salesmen with the information they need to satisfy their cus-

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150. New York Stock Exchange Rule 405(1); American Stock Exchange Rule 411; See also National Association of Securities Dealers, Art. III, § 2.

151. Akio Takeuchi, *Relations Between Securities Companies and Customers*, in JAPANESE SECURITIES REGULATION, *supra* note 18, at 137.

152. Traditionally, the research departments of Japanese securities companies have issued only two types of recommendations: "buy" and "hold." One research analyst was even reprimanded for issuing a "sell" recommendation to his foreign clients. Moreover, the job of many research analysts is to write favorable reports on specific issuers or industries the sales department has decided to promote.

tomers' diverse needs.<sup>153</sup> In order to achieve this, securities companies will need to give their research departments more autonomy.

#### 4. Innovation

Another way to meet customers' (both issuers and investors) increasingly diversified and sophisticated needs is to introduce new investment vehicles and products.<sup>154</sup> The aversion of regulators to innovation in these areas is anti-intellectual and rooted in nostalgia. New products tailored to investors' risk and duration needs have been few and far between. Likewise, few major developments have been made in domestic financing methods over the past years. Clearly the relevant legal and administrative regimes will need to be further liberalized in order to successfully accomplish these changes, but the pent-up demand for new products<sup>155</sup> and financing methods<sup>156</sup> appears to be strong. Development of such products and methods will boost overall efficiency in the market by stimulating trading and liquidity, as well as facilitating more accurate pricing.

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153. In a survey of 3,723 research analysts and fund managers conducted by the Security Analysts Association of Japan, 54% of the respondents stated that analyst reports have little or no influence on share prices as compared with 38% who felt they did have some influence. Furthermore, the survey revealed that analysts were able to research and publish their findings independently and without outside influence only 10% of the time. *Analyst's Report: 50% Say No Effect on Stock Prices*, NIHON KEIZAI SHIMBUN, Oct. 2, 1992 at 17.

154. Ironically, an innovative financial product was recently introduced in the United States which legally guarantees principal while offering the potential for significant appreciation. For example, Bankers Trust offers consumer deposits, sold in denominations as low as \$2,000, and maturing in 5-1/2 years, linked to the Standard & Poors ("S&P") 500 which promise to deliver 100% of any gain in the index at maturity. If the S&P rises 100%, investors receive double their deposit back. If the index stays flat or falls, investors are guaranteed to receive their principal invested. A slightly riskier version offers 110% of the S&P's return over 5-1/2 years, with a trade-off that principal will not decline more than 10%. Similar versions of this product are offered by both banks and brokerage houses. When banks issue them, they are FDIC-insured up to \$100,000. When brokerage houses issue them, they are guaranteed by the firm. Joan Warner, *A Different Kind of Hedge*, BUS. WEEK, Sept. 7, 1992, at 94-95.

155. Daiwa Securities began selling popular dollar-denominated "mortgage funds" based on United States mortgage-backed certificates in June 1990. Most mortgage funds in Japan have terms of 2-3 years and offer relatively high yields. One hundred percent of the foreign exchange risk involved in the buying and selling of these funds is covered by hedging in the foreign exchange futures market. JAPAN ECON. J., Dec. 15, 1990, at 30. Further, strong investor interest in money management funds (MMF) followed their introduction in May 1992 so that by the end of August the balance of funds in MMFs totaled 3.5 trillion. [*MMF: Stock Companies to Sell More*], NIHON KEIZAI SHIMBUN, Sept. 28, 1992 at 47.

156. For example, NTT recently announced that it was planning an issuance of straight bonds under the so-called fixed-price method, rather than the proposal system that was mandatory in Japan until recently. The fixed-price method is the primary method used in the United States and Europe whereby the underwriters price the issue by determining a price they feel the market will bear. Once the price is established, all investors are sold the bonds at that price. This compares to the proposal system in Japan in which preferred customers are given discounts of varying size. The result has been an underdeveloped domestic corporate bond market, with unreliable pricing and limited liquidity. James Sterngold, *Japan Bond Deal Breaks Ground*, N.Y. TIMES, Dec. 10, 1991, at A11.

### 5. Corporate Culture

Finally, the importance of structural reform should not be exaggerated. Perhaps more important than reforming the structure of the securities industry is reforming its corporate culture. For example, practices such as *noruma eigyo* with its overemphasis on sales should be moderated. Nikko Securities recently announced a complete overhauling of its personnel policy.<sup>157</sup> Under the new policy, salesmen will receive low evaluations regardless of how high their sales commissions are if they are found to have churned their clients' accounts, or sold high risk securities to elderly or unsophisticated investors.<sup>158</sup> It will be interesting to see whether more securities companies follow Nikko's example in the future. Indeed, it will be interesting to see whether Nikko is able to effectively implement its new policy.

### C. Investor and Issuer Reforms

Having covered the regulators and securities industry, reformers should next turn their attention to the remaining market participants: issuers and investors. More specifically, the problem needing to be addressed is corporate Japan's dual role of issuer-investor. The primary function of a corporation is to engage in business on a scale beyond the capabilities of individuals by pooling the resources of numerous individual investors, diversifying risks, and limiting liability. In contrast to capital investments, corporate investments in securities should only be justified in situations where such investments are based on a business reason (e.g., investing in the securities of an affiliate or supplier to foster a relationship) or temporary parking of surplus funds in anticipation of future capital investments. On the other hand, investment companies aside, it would be a perversion of the capital market for a corporation to raise funds for the sole purpose of speculating in securities. The tax effect alone would exact a heavy toll on such folly. For example, depending upon the method of taxation chosen by an individual investor, the applicable tax rate for that individual could be as low as 20%,<sup>159</sup> while the applicable rate for most listed corporations is normally 37.5%.<sup>160</sup> Indeed, one Japanese broker suggested in private that excessive corporate fundraising for speculative purposes was one of the main reasons for the stock market crash. An important function of the capital market is to create liquidity and facilitate

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157. [Overhaul of Personnel Evaluation (Policy): Nikko Securities Checking Operating Posture], Nihon Keizai Shimbun, Mar. 30, 1992, at 15.

158. *Id.*

159. Under the current system, individual investors are permitted to regard 5% of the total sale of equities as profits, which then become subject to the 20% withholding tax. By electing this method of taxation, individual investors are able to pay a tax of only 1% on the sale of equities regardless of the amount of actual profits. Yo Makino, *Hike in Capital-Gains Tax on Horizon*, NIKKEI WEEKLY, Nov. 9, 1992, at 4.

160. In addition, in the case of individual investors, the tax rate is levied separately from other types of income. Sozei Tokubetsu Sochiho [Special Taxation Measures Act], No. 26 (1957) (as amended by art. 37-10) (Japan).

the efficient flow of capital from capital-surplus investors to capital-deficit issuers. That the two are one and the same denies the necessity of the capital market.

### 1. *Boosting Dividends*

In order to remedy this situation and prevent it from recurring, surplus capital and speculative profits, the main economic incentives behind this phenomenon, must be attacked. Increasing the dividend payout ratio is the most expedient method to deal with both issues.<sup>161</sup> Increasing the dividend payout ratio in Japan will have far-reaching effects. To begin with, the necessary reduction in a corporation's net worth will concurrently reduce its ability to speculate in the securities market. Secondly, the subsequent return of capital to investors will afford them the opportunity to better decide on the most efficient usage of such capital. The third, and perhaps most important effect of hiking the dividend payout ratio, is to raise the relative importance of dividends in determining yield. The concomitant effect of a higher dividend payout ratio would be to reduce investors' preoccupation with capital gains, thereby reducing the speculative nature of the capital markets.

Implementing this proposal will not be easy. Corporations as issuers benefit from not having to pay out large dividends. Hence, there is little incentive for a corporation as an investor to call for an increase in dividends.<sup>162</sup> Even in the case where it has substantial shareholdings, such investments are usually strategic in nature. Consequently, dividend yield is basically an irrelevant factor. Under the cross-shareholding system, corporations will not sell their shareholdings under most circumstances.<sup>163</sup> With supply restricted, prices tend to rise more readily, and investors are attracted to potential capital gains. Although the average dividend payout ratio increased from 12.9% in 1978 to 16.1% in 1990, the average stock yield decreased from 1.6% to

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161. According to one source, "Japanese companies tend to pay a fixed sum of semiannual or annual dividend (which is expressed as a certain percentage, say 10-15 percent, per annum on the par value per share, which is normally 50) regardless of the performance" during the period. Variation is made for exceptionally profitable or unprofitable terms, or when there are other compelling reasons, such as declaration of large dividends by competitors or commemoration of a major anniversary of the corporation. In the past, new share issues used to take the form of rights offerings at par. In addition, the source states that "[c]onventional rights offerings meant an increase in dividend receipts and also an opportunity to obtain capital gains by selling the newly allotted shares in the market." Now such issues are made at market price. The result is that shareholders' overall returns decreased. Kunio Hamada & Keiji Matsumoto, *Securities Transaction Law in General*, in 5 *DOING BUSINESS IN JAPAN*, § 1.02[3][c] (Zentaro Kitagawa ed. 1991).

162. For example, large stable shareholders such as banks rarely focus attention on dividends alone. Traditionally, investment decisions are based on a composite of various factors such as lending fee income and other resulting revenue producing transactions. *Changing Costs in the Industry*, *NIHON KEIZAI SHIMBUN*, Mar. 2, 1992, at 1.

163. Another reason why corporations favor debt financing over equity financing is due to the difference in tax and accounting treatment between interest on borrowing (which may be deducted as an expense) and on dividends on shares of stock (which are not deductible as an expense but payable from after tax profits).

0.5% over the same period as share price appreciation exceeded the increase in the dividend payout ratio.<sup>164</sup> With a yield of only 0.5%, it is unreasonable to expect many investors to purchase and hold stocks for investment purposes without placing increased emphasis on capital gains. In turn, higher prices serve to lower the yield even further.<sup>165</sup>

Legislatively mandating a specific minimum dividend payout ratio is not an option. Presently, however, the JSDA is attempting to encourage issuers to pay higher dividends. Under present rules, a company must guarantee a specific dividend for two years for all new shares issued at market price. Companies which do not pay at the predetermined dividend rate will have difficulty obtaining an underwriter for their next stock issue.<sup>166</sup> Unfortunately, the attendant lack of flexibility makes this solution far from optimal.

Manipulation of the tax system can be used as an alternative method to raise the dividend payout ratio. This could be accomplished by providing corporations with a tax deduction on a certain percentage of dividends, reducing the tax on individuals' dividend income, and increasing the capital gains tax.<sup>167</sup> In addition, levying a tax on corporate cross-shareholdings<sup>168</sup> as well as corporate holdings of investment securities would create a disincentive for corporations to retain surplus funds. Perhaps the strongest incentive for raising the dividend payout ratio will come from life insurance companies and trust banks. Pension fund managers at these institutions have begun to take a more stringent look at stocks with low dividends. With private pension schemes boasting roughly ¥38.5 trillion (\$296.15 billion) in assets,<sup>169</sup> such views are difficult to ignore.

## 2. Professionalism and Risk Recognition

By and large, the level of professionalism among domestic investors is lamentable. Based on my experience, most major institutional investors are far less sophisticated than their foreign counterparts. In fact, with the exception of size, it is difficult to distinguish them from amateur investors. For example, the Pension Welfare Service Public Corporation has invested about ¥12.6 trillion (\$96.92 billion) to date,<sup>170</sup> yet it has only five full-time employ-

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164. JAPAN INSTITUTE, *supra* note 27, at 43.

165. Nintendo recently announced that it was hiking its dividend to 60, a full 10 over the par value of its stock. NIHON KEIZAI SHIMBUN, Feb. 28, 1992, at 1. Its move earned it the distinction of being the first listed company to declare a dividend in excess of par value. Little attention was paid to the fact that its shares were trading at approximately 9600 at the time.

166. For the fiscal year ended March 1991, companies issuing new equity pledged a dividend of 16.1% on average. The JSDA is hoping to set a 30% minimum payout ratio in an effort to attract more investors to the market. Shigeru Wada, *Stock Dealers Debate Rules for Dividends on New Issues*, NIKKEI WEEKLY, Jan. 25, 1992, at 15.

167. See Tatsuta, *Kyoryoku na Dokuritsu Kisei Kikan Hitsuyo [A Strong Regulatory Regime is Necessary]*, NIHON KEIZAI SHIMBUN, Aug. 10, 1991, at 26.

168. *Id.*

169. Neil Weinberg, *International Fund Managers: Tokyo's Door Opens a Crack*, FIN. TIMES, Nov. 25, 1991, at 2.

170. *Nomura President Resigns as Scandal Widens*, REP. FROM JAPAN, June 24, 1991.

ees managing these investments.<sup>171</sup> To make matters worse, none of these individuals are specialists with any lengthy experience in finance. Moreover, the personnel policy is such that at least one of these employees is rotated out of the department and replaced by someone new each year. The result is an inappropriately small staff with limited experience in managing one of the largest portfolios in the world. Accordingly, it would be unrealistic to expect them to be able to make well-informed independent investment decisions. Thus, it is not surprising that they delegated virtually all investment decisions to securities companies in return for a promise of a certain yield. Indeed, the only decisions such investors normally made concerned the allocation of assets to various securities companies according to the most favorable guarantee.<sup>172</sup>

This attitude toward securities investments is completely irresponsible, but far from unique. Investors, most notably major institutional investors, need to recognize the level of risk involved in their securities investments. After all, there is no such thing as a risk-free investment. Moreover, such an attitude violates the ethical principal of self-responsibility.<sup>173</sup> That is, market participants should act on their own responsibility.

### 3. *Improved Disclosure*

Finally, the loss compensation scandal highlighted the need for improved disclosure. Improved disclosure will not guarantee the quality or price of securities. It should, however, facilitate investors in their investment decisions. In addition, it may also serve as a deterrent to corporate misbehavior. Unfortunately, the Ministry of Finance seems to have misunderstood the relationship of disclosure to the loss compensation scandal and is merely planning to increase the number of companies subject to disclosure requirements.<sup>174</sup> The Ministry would do well to first re-evaluate the effectiveness of the present disclosure system. After all, much of the impetus behind the loss compensation scandal came from companies maneuvering to avoid disclosure of one type or another.<sup>175</sup> In view of this, penalties should undoubtedly be increased for non-disclosure as well as for false or misleading statements. Only when full disclosure is demanded and complied with will scandals of the loss compensation genre wane.

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171. The following information on Pension Welfare Service Public Corporation is based upon the personal knowledge of the author as obtained from confidential sources.

172. In fiscal 1987, ¥60 billion (\$461.54 million) was invested with fund management advisory companies affiliated with Nomura Securities, Daiwa Securities, Yamaichi Securities, and Nikko Securities, the first two receiving 37.7% and 27% respectively, and the last two evenly splitting the remainder. *The Securities Scandal*, REP. FROM JAPAN, June 25, 1991.

173. See Yasuo Takeuchi, *Rethinking the Rules*, JAPAN UPDATE, Oct. 1991, at 8.

174. [*Information Disclosure Requirements Extended to Non-Public Enterprises*], NIHON KEIZAI SHIMBUN, Mar. 12, 1992, at 5.

175. See, e.g., [*Indulging of Enterprises Exposed: Criticism Comes from Ordinary Investors*], NIHON KEIZAI SHIMBUN, Mar. 12, 1992, at 7.

V.  
CONCLUSION

Financial reform is urgently needed in Japan. Guaranteeing principal or yield is not the problem that some would make it out to be. The true problem is systemic and structural in nature. The loss compensation scandal is merely the symptom of a combination of underlying factors. Consequently, remedying the problem is not as simple as amending existing laws or legislating new laws. It is a matter of (i) clarifying and establishing market rules, (ii) clearly delineating the respective roles of issuers, investors, securities companies, and regulators in the capital markets, and (iii) changing fundamental attitudes toward securities investments. Indeed, it is a matter of re-examining the very purpose of Japan's capital markets. Fundamental and structural problems cannot easily be changed, but it is time to begin to change if Japan's capital markets are to remain viable.

APPENDIX A

**Prohibited Acts (pre-1991 version)**

**Article 50.** No securities company, its officers or employees shall do the acts set forth below:

- (1) Acts of inducing a customer to purchase or sell a security or effect other transactions, or securities options trading by offering a definitive prediction that the price of such security or securities options will rise or fall as the case may be;
- (2) acts of inducing a customer to purchase or sell securities index futures contracts by offering a definitive prediction that the contracted index, actual index, the contracted value, or actual value will rise or fall as the case may be;
- (3) acts of inducing a customer to purchase or sell a security or effect other transactions or securities options trading by promising to compensate for any loss, in whole or in part, which such customer may sustain from such securities or options trading;
- (4) acts of inducing a customer to purchase or sell a securities index futures contract by promising to compensate for any loss, in whole or in part, which such customer may sustain from such contract; or
- (5) such other acts than those set forth in the preceding items relating to the purchase or sale of securities, other transactions, securities index futures trading or securities options trading as may be prescribed by an Ordinance of the Ministry of Finance as those which undermine the credibility of the securities industry.

2. The provisions of the preceding paragraph (excluding Item (5)) shall apply *mutatis mutandis* to acts done by any securities company, its officers or employees relating to foreign market's securities futures trading, and those of the same paragraph (excluding Items (1) to (4), inclusive) shall apply *mutatis mutandis* to acts done by such persons relating to foreign market's securities futures trading.

## APPENDIX B

### **Prohibited Acts (revised provisions)**

**Article 50.** No securities company, its officers or employees shall do the acts set forth below:

...

- (3) acts of entering into a contract under which a securities company may determine the purchase or sale (with respect to securities index futures contracts, "purchase or sale" shall depend on whether the entity concerned is a payer or receiver of payments when the actual index or value becomes higher than the contracted index or value, and with respect to securities options trading "purchase or sale" shall depend on whether the entity concerned is a writer or purchaser of the options: these definitions shall apply in the following Item) issue, volume, or price (contracted index or contracted value in the case of securities index futures contracts, and the exercise price in the case of securities options trading: these definitions shall apply in the following Item) of a security, securities index futures contracts or securities options trading in trust, without the customer's consent to each transaction;
- (4) acts of entering into a contract with a trustor which allow a securities company to determine the purchase or sale, issue, volume, or price in the purchase or sale of a security, securities index futures contracts, or securities options trading for the trustor without the trustor's direction in each such transaction to a trust company or a bank permitted to engage in trust business (a "trust company" for purposes of Item (1) of the following Article) when the customer is a trust company.

With respect to Items (3) and (4), however, the Ministry of Finance may exclude such acts as may be prescribed by an Ordinance of the Ministry of Finance if the Ministry determines that such acts will not undermine the protection of the investors, the fairness of trading or the credibility of the securities industry.

### **Prohibition on Loss Compensation**

**Article 50-2.** No securities company, its officers or employees shall do the acts set forth below:

- (1) acts of offering, promising, or inducing a third party to offer or promise to a customer (including a trustor when a trust company requests the purchase or sale of a security, securities index futures contracts, securities options trading, or foreign market securities futures trading by the trustor's decision under a trust contract) or third party designated by the customer, to provide a pecuniary interest to the customer or third party designated by the customer in the event that a loss is incurred or a previously promised profit is

not realized on the purchase or sale of a security or other transactions (excluding transactions which may be prescribed by Government Ordinance, such as transactions with repurchase agreements under which the repurchase price is fixed), securities index futures contracts, securities options trading, or foreign market securities futures trading (hereinafter "the purchase or sale of a security or other transactions");

- (2) acts of offering, promising, or inducing a third party to offer or promise to a customer or third party designated by the customer, to provide a pecuniary interest to a customer or third party designated by the customer in order to compensate for all or a part of a loss suffered by the customer or to supplement the profit earned in the purchase or sale of a security or other transaction; or
- (3) acts of tendering or inducing a third party to tender pecuniary interest to a customer or third party designated by the customer in order to compensate for all or a part of a loss suffered by the customer or to supplement the profit earned in the purchase or sale of a security or other transactions.

2. No customer of a securities firm shall do the acts set forth below:

- (1) acts of promising or inducing a third party to promise acts set forth in Item (1) of the preceding Section to a securities company or a third party in connection with the purchase or sale of a security or other transactions (This provision shall apply only if the customer, by himself or through a third party, requested such actions.);
- (2) acts of promising or inducing a third party to promise acts set forth in Item (2) of the preceding Section to a securities company or a third party in connection with the purchase or sale of a security or other transactions (This provision shall apply only if the customer, by himself or through a third party, requested such actions.); or
- (3) acts of receiving or inducing a third party to receive pecuniary interest set forth in Item (3) of the preceding Section from a securities company or a third party in connection with the purchase or sale of a security or other transactions (This provision shall apply only if the customer, by himself or through a third party, requested such actions).

3. The provisions of Section 1. shall not apply if the offer, promise or tender is to compensate all or a part of losses arising in an incident (i.e., illegal or improper acts of a securities company, its officers or employees as may be prescribed by an Ordinance of the Ministry of Finance as giving rise to a legal dispute: this definition shall apply equally to this Section and Item (2) of Article § 57-2). With respect to Items (2) and (3) of Section 1., the exemption is available only in those cases in which the securities company confirms to the Ministry of Finance, in advance, that the loss was incurred in such an incident or as prescribed by Ordinances.

**4.** The provisions of Section 2. shall not apply to promises set forth in Items (1) and (2) of Section 1. in order to compensate for all or a part of losses arising in an incident as set forth in Section 3.

**5.** Persons seeking confirmation under the exemption provided in Section 3. shall file an application with the Ministry of Finance setting forth the facts of the alleged incident and appropriate Ordinance.

APPENDIX C

**Restrictions on Trading in Securities for One's Own Account, under Discretionary Accounts and Excessive Speculations (pre-1991 version)**

**Article 127.** The Ministry of Finance may prescribe by an Ordinance of the Ministry such matters as the Minister deems necessary and appropriate in the public interest or for the protection of investors in order to restrict the trading of securities by any member of any securities exchange for its own account or for the account of its customers under a discretionary authority granted by such customers with respect to the decision as to whether any security should be bought or sold, the kind of issue, the number and the price of such security or any securities trading effected by any member in such an excessive quantity as the Ministry deems that such trading could disrupt the order of the securities market.

2. The provisions of the preceding paragraph shall apply mutatis mutandis to the trading of securities index futures and securities options. In such cases, the phrase "as to whether any security should be bought or sold" appearing in the same paragraph shall be amended to read "as to whether the customer should take the position of paying for, or receiving the payment of, the money in case the actual index or actual numerical value exceeds the contracted index or contracted numerical value," the word "price" appearing therein shall be amended to read "contracted index or contracted numerical value," the phrase "as to whether any security should be bought or sold" appearing therein shall be amended to read "as to whether the customer should take the position of granting or receiving such options," and the word "price" appearing therein shall be amended to read "the amount of its price."

APPENDIX D

Ratio of Compensation Payments to Commission Revenue

	Year Ended September 1988			Six Months Ended March 1989			Year Ended March 1990			Year Ending March 1991		
	Commission Revenue	Compensation Payment	Ratio	Commission Revenue	Compensation Payment	Ratio	Commission Revenue	Compensation Payment	Ratio	Commission Revenue	Compensation Payment	Ratio
	(¥ million)											
Nomura Securities	391,515	2,209	0.56%	231,645	4,260	1.84%	384,171	21,010	5.47%	218,389	435	0.20%
Daiwa Securities	268,425	891	0.33%	165,011	811	0.49%	296,661	20,414	6.88%	176,572	3,275	1.85%
Nikko Securities	255,788	3,168	1.24%	164,195	2,974	1.81%	306,171	26,958	8.80%	176,888	23,475	13.27%
Yamaichi Securities	230,420	31,856	13.83%	149,271	2,634	1.76%	274,687	11,131	4.05%	159,152	16,367	10.28%
Kokusai Securities	77,321	522	0.68%	47,153	3,255	6.90%	89,837	3,201	3.56%			
New Japan Securities	107,618	4,452	4.14%	65,078	519	0.80%	119,100	9,228	7.75%			
Kankaku Securities	99,942	967	0.97%	56,469	1,335	2.36%	110,710	4,080	3.69%			
Sanyo Securities	88,243	2,748	3.11%	46,511	235	0.51%	97,603	1,766	1.81%			
Wako Securities	84,038	154	0.18%	47,476	50	0.11%	93,849	2,159	2.30%			
Okasan Securities	62,855	195	0.31%	36,757	135	0.37%	71,508	145	0.20%			
Yamatane Securities	33,430	164	0.49%	19,161	83	0.43%	36,204	174	0.48%			
Daiichi Securities	39,307	536	1.36%	25,835	188	0.73%	47,262	4,208	8.90%			
Tokyo Securities	36,177	635	1.76%	22,862	64	0.28%	43,370	330	0.76%			
Marusan Securities	33,067	28	0.08%	18,822	0	0.00%	34,905	522	1.50%			
Toyo Securities	24,889	0	0.00%	16,173	0	0.00%	29,389	336	1.14%			
Taiheyo Securities	34,839	26	0.07%	21,312	189	0.89%	42,897	646	1.51%			
Mito Securities	29,835	195	0.65%	18,843	104	0.55%	35,465	124	0.35%			
Total	1,897,709	48,746	2.57%	1,152,574	16,836	1.46%	2,113,789	106,432	5.04%	731,001	43,552	5.96%

†Change in Accounting Period  
 Source: Nikket Fianansharu 92 (1991).

APPENDIX D CONTINUED

	Compensation Payment (¥ million)	
	Year Ending March 1991	Year Ending March 1992
New Japan Securities	6,603	653,000
Kankaku Securities	828	710,000
Daiichi Securities	760	243,000
Total	8,191	1,606,000

Source: Asahi Shimbun, July 15, 1992.

**Additional Compensation Payments Reported by the Japan Securities Association**

By Fiscal Year

	Amount (¥ million)		Number of Security Firms	Number of Cases*
	Year Ending March 1990	Year Ending March 1991		
Year Ending March 1990	2,649	3	3	34
Year Ending March 1991	6,204	10	10	109
Year Ending March 1992	1,244	6	6	21
Total	10,097	N.A.	N.A.	164

By Company

	Amount (¥ million)		Number of Cases*
	Year Ending March 1990	Year Ending March 1991	
Cosmo Securities	4,558	21	21
Taiheyo Securities	2,146	21	21
Toyo Securities	1,079	16	16
Yamatane Securities	539	8	8
Meiko Securities	493	16	16
Sanyo Securities	419	23	23
Maruman Securities	287	2	2
Mito Securities	266	22	22
Marusan Securities	163	11	11
Naigai Securities	147	10	10
Total	10,097	150	150

\*The Report only includes cases involving compensation in excess of ¥100 million.  
 Source: Nihon Keizai Shimbun, October 21, 1992.

**APPENDIX E**

Actual Methods Used In Loss Compensation Cases

Type of Security	Volume	Buy Transaction		Sell Transaction		Profit (¥ million)
		Date	Price	Date	Price	
Warrant (Futaba Denshi)	3002 warrants	3/19/90	227	3/19/90	1,632	1,405
Warrant (Toda Construction)	\$60 million	3/6/90	2,153	3/9/90	2,601	448
Warrant (Maruzen)	\$25 million	2/26/90	851	2/26/90	1,213	362
*Convertible Bond (Sumitomo Mining)	¥100 million	9/14/89	100	10/31/89	108	8
**Convertible Bond (NEC)	¥500 million	10/17/88	500	11/8/88	510	10
Stock (Nippon Yusen)	300,000 shares	12/20/89	355	12/20/89	368	13
Stock (Sumitomo Metal)	1 million shares	3/15/90	360	3/16/90	366	6
Stock Futures (Nikkei 225 Index)	250 contracts	2/27/90	8,345	2/27/90	8,545	199
Stock Futures (TOPIX)	600 contracts	3/27/90	14,208	3/27/90	14,316	108
Stock Futures (Stock Futures 50)	80 contracts	3/15/88	5,292	3/15/88	5,330	38
Japanese Government Bond	¥15 billion	4/21/88	15,602	4/21/88	15,902	300
Japanese Government Bond Futures	¥20 billion	3/9/88	21,496	3/9/88	21,544	48
Foreign Bond STRIPS	\$142 million	4/25/88	1,893	4/26/88	3,079	1,185
Foreign Bond STRIPS	\$550 million	12/10/87	5,982	12/11/87	7,154	1,172
†Foreign Bond STRIPS	\$20 million			8/5/88	1,504	1,292
†Warrant (SMC)	\$89 million	3/16/90		3/19/90	4,123	1,081
Cash						11

\*New Issue

\*\*Public Offering

†Purchased from Client's Portfolio

Source: Yomiuri Shimbun (1992)

APPENDIX F

Tobashi Disputes & Settlements

(¥ billion)

Securities Company	Client	Type of Security Involved	Amount In Dispute
Daiwa Securities	A.G. Finance <i>(Asahi Glass subsidiary)</i>	Stocks	10.30
Daiwa Securities	Tokyu Department Store	Stocks, etc.	*49.50
Daiwa Securities	Alps Distribution Co. <i>(Alps Electric Co. subsidiary)</i>	Discount JGBs	?
Daiwa Securities	Sunbird Finance <i>(Nagasakiya Co. subsidiary)</i>	Stocks, JGBs, etc.	?
Daiwa Securities	Captain <i>(Kawasho Corp. subsidiary)</i>	?	13.00
Daiwa Securities	Tokyu Land	Stocks, JGBs	*3.56
Maruman Securities	Tokyu Land	Stocks	1.00
Cosmo Securities	Skylark Co.	Zero Coupon Bonds	*41.54
Yamatane Securities	Tokyo Shoken Kinyu Co.	Stocks	*9.20
Yamatane Securities	Maruya Business Associates Inc.	?	*10.20
Yamatane Securities	J.C. Pearl Corp. <i>(Hanwa Co. subsidiary)</i>	Stocks	0.22

\*Actual Amount of Settlement

Source: Independently Compiled from Various Japanese Newspapers

APPENDIX G

Brokerage Commission Rates

1. Shares & Warrants (amended on Jun. 4, 1990)

The Value of Shares/Warrants Traded	Brokerage Commission Rates
Up to ¥1 million	1.150%
Over ¥1 million and up to ¥5 million	0.900%
Over ¥5 million and up to ¥10 million	0.700%
Over ¥10 million and up to ¥30 million	0.575%
Over ¥30 million and up to ¥50 million	0.375%
Over ¥50 million and up to ¥100 million	0.225%
Over ¥100 million and up to ¥300 million	0.200%
Over ¥300 million and up to ¥500 million	0.125%
Over ¥500 million and up to ¥1 billion	0.100%
Over ¥1 billion	0.075%

\*Minimum Brokerage commission of ¥2,500.

†Above rates also apply to preferred stocks, subscription rights, and foreign stocks.

2. Convertible & Warrant Bonds (amended on Oct. 5, 1987)

The Value of Convertible/Warrant Bonds Traded	Brokerage Commission Rates
Up to ¥1 million	1.00%
Over ¥1 million and up to ¥5 million	0.90%
Over ¥5 million and up to ¥10 million	0.70%
Over ¥10 million and up to ¥30 million	0.55%
Over ¥30 million and up to ¥50 million	0.40%
Over ¥50 million and up to ¥100 million	0.25%
Over ¥100 million and up to ¥1 billion	0.20%
Over ¥1 billion	0.15%

3. Bonds (amended on Oct. 5, 1987)

Kinds of Bonds/ Total Par Value	Per ¥100 in Par Value Traded					
	< ¥5 mil.	> ¥5 mil. < ¥10 mil.	> ¥10 mil. < ¥50 mil.	> ¥50 mil. < ¥100 mil.	> ¥100 mil. < ¥ bil.	> ¥1 bil.
Govt. bonds	¥0.40	¥0.35	¥0.30	¥0.25	¥0.10	¥0.05
Govt. guar. bonds, local govt. bonds, foreign govt. bonds, and other bonds designated by stock exchange	¥0.60	¥0.50	¥0.40	¥0.30	¥0.15	¥0.10
Other bonds	¥0.80	¥0.65	¥0.50	¥0.35	¥0.20	¥0.15

Source: Japan Securities Research Institute

APPENDIX H  
 LIST OF COMPENSATED CLIENTS  
 (in ¥millions)

NOMURA SECURITIES CO., LTD.

*List of Compensated Clients Given to MoF*

1. Hitachi, Ltd.	2,173
2. H.M. (Individual)	1,900
3. MIF	1,405
4. Joshin Denki	662
5. Komatsu	632
6. Nihon Sekiyu	622
7. Mizuno	622
8. Miyagi Prefectural Cooperative (Miyagi-ken Shinren)	451
9. Shinko Lease	451
10. Refine	418
11. Kyoto-city Employee Cooperative (Kyoto-shi Kyoso)	371
12. Tokyo Broadcasting	361
13. Kobe-city Employee Cooperative (Kobe-shi Kyoso)	361
14. Kai Credit Cooperative (Kai Shinyo Kumiai)	351
15. Stanley Electric	351
16. Eisai	333
17. Nishi Nippon Bank (Nishi Nippon Ginko)	309
18. Shizuoka Prefectural Cooperative (Shizuoka-ken Shinren)	309
19. Higo Family Bank (Higo Family Ginko)	301
20. Nitto Denko	298
21. Nishishiba Electric (Nishishiba Denki)	298
22. Horon City	224
23. Ishibashi Industries (Ishibashi Sangyo)	220
24. Taiyo Sanso	220
25. Sumitomo Metal Industries (Sumitomo Kinzoku Kogyo)	211
26. Hekikai Credit Association (Hekikai Shinyo Kinko)	206
27. Yaizu Credit Association (Yaizu Shinyo Kinko)	201
28. Meitetsu Sogo Kigyo	200
29. Hyogo Prefectural Cooperative (Hyogo-ken Shinren)	200
30. Shin Nihon Kohan	170
31. Japan Air Lease (Nikko Lease)	163
32. Toyobo Finance	140
33. Obayashi Gumi	100
34. Tsugami	100
35. Tokai	100
36. Ehime Prefecture Labor Fund (Ehime-ken Rokin)	100
37. Unitika	80
38. Kyoto Prefectural Cooperative (Kyoto-fu Shinren)	80
39. Showa Sangyo	80
40. Osaka Merchant Shipping/Mitsui Shipping (Osaka Shosen Mitsui Senhaku)	72
41. Tsuchiura Credit Association (Tsuchiura Shinyo Kinko)	70
42. Fuso Finance	70
43. Tokyo Shogin Shinyo Kumiai	50
44. Ai Esu Intaa	30
45. Arakawa Credit Association (Arakawa Shinyo Kinko)	30

**TOTAL (44 Corporate, 1 Individual)** 16,123

*Portion Denied to the National Tax Bureau*

1. Showa Shell Sekiyu 2,359
2. Hitachi, Ltd. 2,173
3. MIF 1,405

The rest of the list given to the National Tax Bureau was identical to that listed above under "List of Compensated Clients Given to MOF."

**TOTAL (45 Corporate)** 16,582

*Portion Subjected to Revised Decisions by the National Tax Bureau*

1. Employees Pension Welfare Association (Nenkin Fukushi Jigyodan) 4,941
  2. Showa Shell Sekiyuu 2,030
  3. Nanki Kanko 1,251
  4. Tokuyama Soda 775
- TOTAL (4 Corporate)** 8,997

**DAIWA SECURITIES CO., LTD.**

*List of Compensated Clients Given to MoF*

1. Toyota Motor 2,188
2. Nissan Motor 1,595
3. Meitetsu Sogo Kigyo 1,288
4. Matsushita Electric Industrial 1,253
5. Kurefin 1,077
6. C. Itoh & Co. 929
7. Hokuriku Seiyaku 822
8. Kyoto Credit Association (Kyoto Shinyo Kinko) 790
9. Sumitomo Corp. 758
10. Hitachi, Ltd. 755
11. Onward Kashiyama 621
12. Nagase & Co. 676
13. Fukuoka Prefectural Cooperative (Fukuoka-ken Shinren) 645
14. Shisheido Finance 620
15. Taiyo Fishery 607
16. Refine 525
17. Osaka Merchant Shipping/Mitsui Shipping (Osaka Shosen Mitsui Senhaku) 521
18. Mitsubishi Petrochemical 405
19. Nissho Iwai 404
20. Showa Shell Sekiyu 339
21. Suntory 309
22. Kitazawa Bulb 267
23. NAF 266
24. Intec 261
25. Okayama Sekiyu 223
26. Sanyo Kaihatsu 223
27. Toshiba Ceramics 221
28. Ishioka Credit Association (Seibj Shinyo Kinko) 208
29. Seibu Credit Association (Seibu Shinyo Kinko) 208
30. Higo Family Bank (Higo Family Ginko) 201

31. AG Finance	172
32. Hyogo Prefectural Cooperative (Hyogo-ken Shinren)	157
33. Okayama Mutual Insurance Federation of Agricultural Cooperatives (Okayama Kyosairen)	150
34. Kokusai Denshin Denwa	145
35. Kyowa Hakko Kogyo	141
36. Chiyoda Corp. (Chiyoda Kako Kensetsu)	130
37. Renown	122
38. Okabe	119
39. Rasa Industries	117
40. Kishu Prefectural Cooperative (Kishu Shinren)	106
41. Saga Prefectural Cooperative (Saga-ken Shinren)	102
42. Ryoden Trading	101
43. Chiba Prefectural Cooperative (Chiba-ken Shinren)	80
44. Saga Bank	67
45. Terumo	61
46. Nakatsugawa Credit Cooperative (Nakatsugawa Shinyo Kumiai)	59
47. Shingakukai	56
48. Akebono Brake Industry	50
49. Ajinomoto Finance	49
50. Hyakugo Lease	45
51. Obayashi Gumi	40
52. Japan Synthetic Rubber	39
53. Fujikoshi	21
54. Sumitomo Heavy Industries	7
TOTAL (54 Corporate)	21,865

*Portion Denied to the National Tax Bureau*

1. Toyota Motor	2,188
2. Meitetsu Sogo Kigyo	1,320
3. Nissan Motor	1,258
4. Matsushita Electric Industrial	1,170
5. Kyoto Credit Association (Kyoto Shinyo Kinko)	790
6. Sumitomo Corp.	758
7. Hitachi, Ltd.	755
8. Nagase & Co.	676
9. C. Itoh & Co.	545
10. Refine	471
11. Showa Electric Wire & Cable Co., Ltd.	423
12. Osaka Merchant Shipping/Mitsui Shipping (Osaka Shosen Mitsui Senhaku)	400
13. Kurefin	359
14. Onward Kashiya	333
15. Seibu Credit Association (Seibu Shinyo Kinko)	210
16. Higo Family Bank (Higo Family Ginko)	201
17. Meisai Intaa	200
18. Daito Gyorui Co., Ltd.	162
19. Okayama Mutual Insurance Federation of Agricultural Cooperatives (Okayama Kyosairen)	150
20. Saga Prefectural Cooperative (Saga-ken Shinren)	102
21. Chiba Prefectural Cooperative (Chiba-ken Shinren)	80
22. Saga Bank	67
23. Hyakugo Lease	45

**TOTAL (23 Corporate)** 12,664

*Portion Subjected to Revised Decisions by the National Tax Bureau*

1. Kurefin	484
2. Onward Kashiyama	272
3. Kitazawa Bulb	267
4. Ishioka Credit Cooperative (Ishioka Shinren)	209
5. C. Itoh & Co.	138
6. Meisei International	123
<b>TOTAL (6 Corporate)</b>	<b>1,468</b>

**NIKKO SECURITIES CO., LTD.**

*List of Compensated Clients Given to MoF*

1. Koritsu Gakko Kyosai (Pension fund for public school employees)	3,645
2. Nippon Oil	2,220
3. Sekisui Chemical	1,922
4. Tomen Corp.	1,921
5. Marubeni HK	1,836
6. Intec Inc.	1,555
7. Keisatsusai Kyosai (Pension fund for police officers)	1,446
8. Nippon Shinyaku	1,171
9. Mitsubishi Petrochemical	1,004
10. Kita Nippon Bank	945
11. MCF	889
12. Rokin Toshi Komon (Investment Consultant)	848
13. Nitto Denko	823
14. Kawasaki Steel Corp.	801
15. Chiho Shokuin Kyosai (Pension fund)	746
16. Mitsubishi Oil	729
17. Zenkoku Shichoson Kyosai (Pension fund)	493
18. All Nippon Airways	437
19. Tomen Finance	436
20. Intec Lease	409
21. Kirin Beer	366
22. Chiho Komuin Kyosai (Pension fund)	349
23. NIF	301
24. Onoda Cement	280
25. Matsushita Electric	255
26. Taisei Prefab	206
27. Nigata Chuo Bank	200
28. Koito Mfg.	190
29. Hitachi Lease	184
30. Ishikawajima-Harima Heavy Industries	169
31. Mitsui Construction	160
32. Fukushima Ginko	150
33. Nippon Steel Chemical	142
34. Naetsu Credit Association (Naetsu Shinyo Kinko)	120
35. Onoda Finance	106
36. Tokyo Shokuin Kyosai (pension fund)	103
37. Sumitomo Metal Industries	101
38. Miyagi Rokin	63
39. Tokyo Broadcasting System	61

40. Shiga Bank	20
41. Asahi Denka Kogyo	9
TOTAL (41 Corporate)	27,811

*Portion Denied to the National Tax Bureau*

1. Koritsu Gakko Kyosai (Pension fund for public school employees)	3,716
2. Nippon Oil	1,896
3. Marubeni	1,600
4. Sekisui Chemical	1,365
5. Keisatsusai Kyosai (Pension fund for police officers)	1,355
6. Fuyo Auto Lease	1,260
7. Nippon Shinyaku	1,000
8. Nitto Denko	823
9. Uni Charm Corp.	736
10. Kyoto Credit Association (Kyoto Shinyo Kinko)	480
11. Mitsubishi Petrochemical	473
12. Tomen Finance	448
13. All Nippon Airways	439
14. Sumitomo Life Insurance	312
15. Toyo Metals	304
16. Tokyo Broadcasting System	291
17. Matsushita Electric	259
18. Kawasaki Steel Corp.	202
19. Hitachi Lease	199
20. Koito Mfg.	187
21. Nippon Steel Chemical	152
22. Sumitomo Metal Industries	109
23. Nishi-Nippon Bank	103
24. Onoda Finance	102
25. Tomen	59
26. Onoda Cement	41
TOTAL (26 Corporate)	17,911

*Portion Subjected to Revised Decisions by the National Tax Bureau*

1. Nippon Oil	829
2. Tomen	728
3. Fuyo Auto Lease	448
4. Marubeni	422
5. Employees Pension Welfare Association (Nenkin Fukushi Jigyodan)	413
6. Hanwa Kogyo	403
7. Nippon Shinyaku	243
8. Toshoku Finance	230
9. Saitama Bank (no longer exists)	202
10. Fukuoka-ken Shinyo Kinko Rengokai	164
11. Kyushu Passenger Rail	110
12. Kotobukiya	99
13. Nippon Paint	97
14. Daiwa House Industry	63
15. Tomin Capital	51
16. Royal Co., Ltd.	48
17. C. Itoh & Co.	29

TOTAL (17 Corporate) 4,589

**YAMAICHI SECURITIES CO., LTD.**

*List of Compensated Clients Given to MoF*

1. JC Paaru*	4,070
2. Gakken Co., Ltd. (Gakushu Kenkyusha)	3,993
3. YGF	3,914
4. Matsushita Electric	2,702
5. Tsumura & Co.	2,201
6. Hanwa Kogyo	2,077
7. Yamaguchi Prefectural Cooperative (Yamaguchi-ken Shinren)	1,398
8. Tsumura Tatemono	1,292
9. Shinko Building	1,185
10. Olympus Kogaku Kogyo	1,172
11. Ohagi Kogyo	948
12. Fusion	946
13. Komatsu Finance	940
14. F.K. (individual)	896
15. Marubeni America	882
16. Sumitomo Metal Industries	866
17. Daiwa House Industry	858
18. Kandenko	848
19. PGL Investment	848
20. Marubeni Panama	841
21. Schkochukin	740
22. Marubeni Energy	659
23. Fukuoka Rokin	500
24. Captain	460
25. Tomisho	454
26. Hokusan	438
27. Intec Inc.	415
28. Koyosha	372
29. Sanyo Electric	348
30. Refine	325
31. Tonen Energy	293
32. Noritake Co., Ltd.	251
33. Iryo Hojin Maruyamakai	238
34. Azabu Cement	233
35. Eighteenth Bank	200
36. Nippon Tosho Fukyu	192
37. Kyoto Prefectural Cooperative (Kyoto-fu Shinren)	174
38. Suminoe Finance	151
39. Nissin Electric	151
40. Kisoji	132
41. Hyogo Prefectural Cooperative (Hyogo-ken Shinren)	107
42. Higo Family Bank	101
43. Kyorin	92
44. Yoraku	68
45. Furuno Electric	61
46. H.Y. (Individual)	58
47. Asahikawa Shoko Credit Cooperative (Asahikawa Shinyo Kumiai)	54
48. NipponSeiki	53
49. Eiko Capital	50

50. Eiwa Store	37
TOTAL (48 Corporate, 2 Individual)	40,284

*Portion Denied to the National Tax Bureau*

1. Koyosha	372
2. Noritake Co., Ltd.	250
3. Kisoji	131
TOTAL (3 Corporate)	753

*Portion Subject to Revised Decisions by the National Tax Bureau*

1. Tsumura	2,209
2. Hanwa Kogyo	2,007
3. Tsumura Tatemono	1,275
4. Shinko Building	1,186
5. Gakken Co., Ltd. (Gakushu Kenkyusha)	985
6. Fusion	926
7. F.K. (Individual)	878
8. Nichirei Corp.	714
9. Achilles	596
10. Nihonbashi Kogyo	544
11. Komatsu Finance	470
12. Senshu Shoji	429
13. Canon Sales	384
14. Kaetsu Gakuen	320
15. Shonan Sun and Sea	182
16. Nippon Tosho Fukyu	177
17. Sekisui Chemical	139
18. Sapporo Finance	131
19. Tomisho	121
20. Fuji Bank Factor	102
21. Ichikoh Industries	71
22. Arumusuto	63
23. Jetto	48
24. Zefirusujeandoje	47
TOTAL (23 Corporate, 1 Individual)	14,004

Notes: Translated from Nihon Keizai Shimbun, July 29, 1991, by Susan Kobayashi. Phonetic translation from Katakana. Exact spelling in English unknown. Companies listed on the Tokyo Stock Exchange are included using the English names from the Japan Company Handbook.