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# The Establishment of a Fund System to Protect Investors

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*In the Financial System Reform Act enacted by the Japanese Diet (Parliament) on June 5, 1998 a fund system to protect investors will be introduced in place of the current Deposited Securities Compensation Fund in December 1998 as a new version of the safety net. This report will outline this new fund system and discuss its significance and future problems.*

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## 1. Background to the Establishment of a Fund System to Protect Investors

When a securities company fails, it is vital for customers' assets in its custody to be quickly returned to them from the viewpoint of protecting investors and maintaining confidence in the securities market. In fact, however, there have been quite a few cases in various countries where collapsed securities companies have failed to return customers' assets in their custody. That's why many countries have established their own compensation systems.

In Japan a nonprofit corporation, the Deposited Securities Compensation Fund, which was established in 1969 specializes in compensating for customers' assets in the custody of securities companies. The plan to establish the DSCF emerged during the securities market recession in the latter half of 1963, and at first its predecessor, an association type of fund, was established.

This Deposited Securities Compensation Fund is very weak and unstable because the members' contributions are based on no definite rates and on voluntary donation, and because no borrowing is permitted. To make matters worse, as securities companies began to register poor business results due to the stock market stagnation after April 1994, they stopped paying their membership contributions.<sup>1</sup>

There were no cases requiring payment of compensation by the DSCF until 1996, but it faced acute fund shortages caused by a series of collapses of securities companies, such as Ogawa, Echigo, Sanyo and Maruso Securities Company in 1997. Sanyo's failure had a particularly extensive impact on the industry, and the DSCF took two special measures: (1) no application of the compensation ceiling of ¥2 billion per securities company and (2) approval of borrowing (which is not stipulated in donative action) for the purpose of compensation.

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<sup>1</sup> The rate of contribution just prior to the suspension of contributions was set by the board of directors on the basis of annual trading (members' account and customers' account) at ¥2/1,000 per ¥100 for stocks and at ¥2/10,000 per ¥100 for bonds.

In the course of successive business failures of securities firms, voices were raised for the expansion of DSCF as the securities version of a safety net, and this led to the legislation for the establishment of the new fund System.

## **2. Outline of a Fund System to Protect Investors in the Financial System Reform Act**

### **1) Positioning of a Fund System to Protect Investors**

A fund system to protect investors will be established in place of the current Compensation Fund as a corporation under the Securities and Exchange Law in December 1998. The new fund is intended to “protect investors and maintain confidence in securities trading” by engaging in such matters as payment to customers as the current DSCF does (Article 79-21 of the amended Securities and Exchange Law).

The amended law requires securities companies to join any one of the funds as its members (Article 79-27), and thus more than one fund are likely to be established. In establishing the fund, more than 20 securities companies, which wish to be its members, should be its promoters (Article 79-29). For the purpose of this law, “securities companies” are stock companies stipulated in Article 28 of the amended Securities and Exchange Law, that is those whose registration has been acknowledged by the Prime Minister. Securities companies to be established under Article 28 of the Law and those to be registered under Clause 1, Article 3 of the Law regarding foreign securities companies are obligated to join any new fund at the time of application for their establishment.

### **2) Relations with Separated Management of Customer Assets**

Customers’ assets in the custody of securities companies must be separately managed and fully protected even in the event of business failure of the securities company. This is an important factor in considering the establishment of the new fund.

Separated management of customer assets is classified as “special account for customer assets” opened at banks in the U.S., and as “hold on trust” in Britain. By comparison, assets for separated management have been limited to securities in safe custody under Japan’s Securities and Exchange Law. The recent amendment of the law requires securities companies to keep customer assets in separated management including moneys. It is now stipulated that securities companies should safekeep securities and moneys entrusted by their customers separately from their own assets. It is also stipulated that in safekeeping customers’ separated money (moneys to be returned to customers in the event of business closing), securities companies should entrust it to trust companies, etc.. (Article 47 of the Securities and Exchange Law).

Under this law, cash that securities companies temporarily keep in custody until customers sell securities and buy other issues, and moneys such as margin money to be paid to securities companies for margin transaction are also put under separated management. The role of the fund is to cope with the situation, in which securities companies find it beyond them to compensate customers for their losses, by thoroughly implementing separated management.

**Table 1 Comparison of the New Fund with the Deposited Securities Compensation Fund**

	<b>Investor Protection Fund (IPF)</b>	<b>Deposited Securities Compensation Fund (DSCF)</b>
1.Establishment	Dec. 1998; Planned to be established as a corporation under the Securities and Exchange Law	Established as an incorporated foundation in 1969.
2.Organizations Covered	Securities companies (including foreign firms)	Securities companies (including foreign firms)
3.Compensation (1)Recipients	“General customers” (excluding qualified institutional investors and others specified by the government ordinance)	Customers who entrusted securities companies with money and securities (excluding executives of securities companies and those with equal power of control)
(2)Ceiling for Compensation	An amount specified by the government ordinance (¥10 million per person). This ceiling does not apply as an exceptional measure until March 2001.	¥2 billion per securities company.
4.Member Contribution	Obligatory	Voluntary
5.Borrowing	Borrowing from the Bank of Japan with the government’s guarantee (exceptional measure up to March 2001).	No rule for borrowing.
6.Management of Assets	Surpluses from business and funds are managed by the following methods. <ul style="list-style-type: none"> <li>• Holding of government bonds and other securities designated by the Minister of Finance.</li> <li>• Depositing at financial institutions designated by the Minister of Finance.</li> <li>• Other methods stipulated by the Ministry of Finance’s Ordinance.</li> </ul>	Assets should be managed and controlled efficiently by the following methods. However, management of stock certificates and beneficiary certificates of stock investment trusts should not exceed 30% of the basic assets. <ul style="list-style-type: none"> <li>• Government and local government bonds.</li> <li>• Stock certificates listed on the securities exchanges.</li> <li>• Beneficiary certificates of securities investment trusts.</li> <li>• Deposits &amp; savings with financial institutions and postal savings.</li> <li>• Moneys trusts with banks engaged in trust business.</li> <li>• Foreign certificates.</li> <li>• Lending of money and securities to security financing companies.</li> </ul>
7.Size of Fund	¥30 billion at the start, which will be increased to about ¥50 billion. According to a press report, the Japan Securities Dealers Association has also requested the following organizations to contribute to the new fund. <ul style="list-style-type: none"> <li>• Capital Market Promotion Foundation: ¥7 billion</li> <li>• Japan Joint Securities Foundation: ¥5 billion</li> <li>• The Bond Underwriting Association of Japan: ¥6 billion</li> <li>• The Japan Securities Dealers Association : ¥2 billion.</li> </ul>	About ¥35.9 billion (end of September 1997).

Source: Nomura Research Institute

### 3) Compensation

Under the present system, the ceiling for compensation to customers when the reason for compensation occurs is set at ¥2 billion per securities company. Customers eligible for compensation include those who have entrusted money and securities to securities companies, but exclude executives of the securities companies involved in compensation and those with equal power of control.

The recent amendment of the law changes customers eligible for compensation and the ceiling of compensation to the following. Customers eligible for compensation are limited to “general customers”, excluding qualified financial institutions, the state, local governments, and others stipulated by the government ordinance. “General customers” are customers of the head offices and

other domestic offices of securities companies, who engage in trading related to securities business or business pertaining to securities business (Article 79-20).

The ceiling for compensation is set at an amount determined by the government ordinance (Article 79-57), and is expected to be ¥10 million per customer, the same compensation amount for deposit insurance.

#### **4) Membership Contributions**

The present DSCF has been financed only with voluntary donations by member securities companies, which are under no obligation to pay contributions. However, the surfacing of the collapse of Sanyo Securities Company revealed the weakness of the DSCF's financial foundation.

Against this background, the recent amendment of the law requires member securities companies to pay their shares of contributions to the fund to which they belong in order to finance its activities (Article 79-63). Member securities companies' contributions will be determined by the calculating method stipulated by business rules. Should they fail to pay by the deadline, member securities companies will be required to pay arrears (calculated by multiplying the unpaid contributions by annual rate of 14.5% for the number of days from the following day of the deadline to the day of actual payment) (Article 79-65).

#### **5) Borrowing of Funds**

The present DSCF scheme has no provision for borrowing of funds. The recent amendment allows the fund system to borrow funds (including rollover) from financial institutions (banks, securities companies and others stipulated by the Ministerial of Finance's Ordinance), when deemed necessary, with the approval of the Minister of Finance (Article 79-72).

#### **6) Extraordinary Measures**

The new fund does not set the ceiling for compensation per customer until March 2001 and takes the following two extraordinary measures until March 2001.

- (1) The fund system can borrow funds from the Bank of Japan as well as from financial institutions when it undertakes activities for investor protection.
- (2) In that event, the government may guarantee the borrowing in question.

### **3. Investor Protection Funds in the U.S. and Britain**

The investor protection fund systems in the U.S. and Britain are outlined below.

## **1) The U.S.**

The U.S.'s compensation fund, the Securities Investor Protection Corporation, was established in 1970 as a non-profit organization under the Securities Investor Protection Act. The SIPC's member securities companies are required to pay contributions at the rate not higher than 1% of their total revenues. (The SIPC's balance at the end of 1996 stood at \$1.02 billion.) In addition, the SEC is permitted to provide the SIPC with loans up to \$1 billion by borrowing from the Department of Treasury. The SIPC's financial foundation is thus more solid than that of Japan's DSCF.

The ceiling for compensation is set at \$500,000 per customer (\$100,000 for claims involving cash). Executives of the securities companies in question, shareholders with a stake of over 5%, and those with control over the management of the securities companies are excluded from those eligible for compensation.

## **2) Britain**

Britain's compensation fund system, the Investors Compensation Scheme, is a non-profit organization established in 1988 by the Securities and Investments Board (SIB) pursuant to Article 54 of the Financial Services Act 1986. The ICS provides compensation to the customers of licensed traders belonging to the SIB and three self-regulatory organizations (SROs) (Personal Investment Authority (PIA), Securities and Futures Authority (SFA), and Investment Management Regulatory Organization (IMRO)).

For years, the ICS forced the licensed traders to pay contributions ex post facto in response to customers' claims for compensation. However, the SRO failed to pay its contribution, and some member traders also resisted payment. The ICS stood on the verge of collapse, and the need to solidify its financial foundation was voiced.

In January 1997, the SIB made a proposal concerning the estimated claims for compensation and the establishment of a reserve fund in preparation for contingencies. Many compensation funds have also been integrated since the SIB's reorganization into the Financial Service Authority in October 1997.

## **4. Future Objectives**

With the institutionalization of the new fund, Japan will have established the framework for a safety net for securities. Together with thorough separated management of customer assets, this system will help enhance confidence in Japan's securities market.

However, many problems remain to be solved, including how to calculate securities companies' membership contributions. These companies are obligated to pay contributions to the fund, but they are divided over how to calculate the amount of contribution. The Japan Securities Dealers Association is considering a plan to collect contributions from securities companies based on the trading amount of stocks, bonds and futures trading, etc.

**Table 2 The Compensation Fund System in the U.S. and Britain**

	<b>U.S.</b>	<b>Britain</b>
Organization	Securities Investor Protection Corporation (SIPC)	Investors Compensation Scheme (ICS)
Establishment	Established as a non-profit organization under the Securities Investor Protection Act of 1970.	Established in 1988 as a compensation fund under Article 54 of the Financial Services Act 1986 and the SIB investors compensation rules of 1986.
Supervisory Agency	Securities and Exchange Commission (SEC)	Securities and Investments Board(SIB) - Financial Services Authority (FSA)
Traders Covered	SIPC member securities traders (including foreign traders)	Licensed traders who are members of self-regulatory organizations (including foreign traders)
Membership Contributions	SIPC collects contribution in the amount no higher than 1% of members' total revenues	ICS requires SROs to collect contributions from licensed traders according to their own standards.
Content of Compensation	Compensation is provided for customers' assets (securities and cash) when a securities firm receives protective order from the federal court (equivalent to adjudication of bankruptcy) and fails to fully return the customers' money and securities in its custody.	Compensation is provided when licensed member traders of self-regulatory organizations go into default, and investors duly claim compensation. Compensation covers "investment instruments" for the purpose of the Financial Services Act, including stocks, futures options and unit trusts.
Ceiling for Compensation	\$500,000 per customer (of which \$100,000 is for claims for cash).	Full amount up to 30,000 pounds, 90% for 30,000 to 50,000 pounds. The ceiling is 48,000 pounds.
Borrowing	SEC provides loans up to \$1 billion (by borrowing in Treasury notes from the Department of Treasury).	There is a quota for unsecured borrowing up to 40 million pounds (on a private sector basis).
Brief History and Present Status	SIPC was established when many securities companies failed to meet customers' claims after their back office crisis in 1968-70. During 25 years (1971-95), 226 claims were handled, and a total of \$2.5 billion was returned, including SIPC funds worth \$186 million. SIPC's balance at the end of 1996 stood at \$1.02 billion.	The Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA) suffered from a heavy burden of compensation due to members' successive collapses and was forced to merge with the Life Assurance and Unit Trust Regulatory Organization (LAUTRO) in 1994. A factor for its financial difficulty is attributed to its generous compensation paid even for claims caused by disobedience of accountability. In January 1997 the SIB proposed an increase in ICB funds.

Source: Nomura Research Institute

However, ten foreign securities firms, including Goldman Sachs and Merrill Lynch, have presented a written opposition to the Association. Their reasoning is that the calculation method based on trading volume is irrational and excessively burdens foreign companies. As a rational method of sharing, they propose a method of calculation on the basis of the balance of customers' assets in their custody.<sup>3</sup> It should be noted that the intention to minimize their share of contribution is also shared by Japanese securities companies.

There is also a problem of whether to take over the DSCF's assets and liabilities. It was found that Yamaichi Securities Company, which decided to close its operation in November 1997, had gone into insolvency and had difficulty in repaying special loans from the Bank of Japan. The new fund may have to succeed Yamaichi's debts as well and repay special BOJ loans. How to deal with these problems will affect the projected establishment and management of the fund and its future development.

3 *Nikkei Kinnyu Shinbun*, April 30, 1998, p.3