An Optimum System for Supervising Japan's Securities Markets

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In order for a securities market to function properly there must be a system in place to detect and put a stop to any unfair trading activity or any illegal solicitation by securities companies and other market participants. In Japan, the Financial Services Agency (FSA) and one of its arms, the Securities and Exchange Surveillance Commission (SESC), is responsible for supervising securities markets and securities professionals in cooperation with the country's self-regulatory organizations such as the Securities Dealers Association (JSDA) and stock exchanges. However, many believe that Japan is underregulated in this area compared with the United States. Similarly, some people are of the opinion that the current system of regulation and supervision needs to be changed. This report attempts to assess the current system of supervising Japan's securities markets from a historical and comparative perspective.

1. Need for More Rigorous Market Supervision

Under the banner of "freedom, fairness and globalization" Japan's "Big Bang" program of financial reform ushered in a period of major change on the country's securities markets. The program was characterized by the liberalization and deregulation needed to realize its goal of achieving "fair" markets—as exemplified by measures such as (1) the replacement of the licensing system for securities companies by a registration system, (2) the abolition of all restrictions on equity brokerage commissions; and (3) the abolition of the requirement that all trades be executed on a stock exchange. In addition, many of the reform measures that were adopted were modeled on those in use in Europe and the United States (especially in the United States and the United Kingdom—two of the countries with the most developed securities markets) in an effort to ensure that Japan's securities markets be "global."

A number of measures were taken to ensure that Japan's securities markets were "fair": a requirement was adopted that disclosure be on a consolidated basis; investment trusts were required to disclose their accounts; securities companies were required to segregate client assets from their own assets; and the Investor Protection Fund was set up to ensure that losses derived from collapse of a securities company would be compensated. However, these reforms did not attract the same attention as those designed to foster competition (e.g., by means of deregulation), and Japan's Big

Bang program was criticized in many quarters for emphasizing the aspects of "freedom" and "globalization" at the expense of (or even for ignoring) the aspect of "fairness."

In response to this criticism, the Discussion Group on New Financial Trends, established in July 1997, set about drawing up a "comprehensive set of financial laws for the protection of financial service users" that was modeled on the UK Financial Services Act of 1986 and could well be called a Japanese version of the Financial Services Act. The Group's discussions eventually led to the enactment of the Financial Products Sales Law, which established common compensation rules and made it a requirement for financial service companies selling products where the value of an investment may fall as well as rise to explain this risk to prospective clients.[1]

However, investor protection rules—even if they are detailed and backed up by the law—are just pie in the sky unless there is a proper system of detection and supervision. In fact, many believe that the system of regulating and supervising Japan's securities markets is inadequate. Even some of those involved in the recent debate on how to reinvigorate these markets have said that the system of supervision needs to be improved to ensure that investors are adequately protected. For example, the report "A Program for Structural Reform of Japan's Securities Markets: Creating the Conditions for Retail Investors to Play a Key Role," published by the Financial Services Agency in August 2001, cites a "lack of confidence in the securities markets" as one of the main reasons retail investors are reluctant to commit themselves. According to the report, monitoring of unfair trading practices is inadequate and the selling practices of some securities companies are questionable.

If—even after the implementation of Japan's Big Bang program of financial reform—there are doubts about the fairness of Japan's securities markets, urgent action needs to be taken to strengthen those agencies responsible for regulating and supervising those markets. There is no doubt that Japan's Securities and Exchange Surveillance Commission, which has a staff of only 120, pales in comparison with the US Securities and Exchange Commission (SEC), an independent administrative organ whose five members are appointed by the president and which has a staff of about 3,000. The SEC has quasi-legislative and quasi-legal powers—e.g., the power not only to enact rules but also to ban unfair practices and to levy fines.

There is no doubt that the SEC's activities have helped to build confidence in US securities markets. This in itself explains why there have been calls in Japan for a

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1 Masanobu Iwatani, "The Financial Products Sales Law," Capital Research Journal, Summer 2000.

"Japanese SEC."[2] However, any consideration of this issue needs not simply to compare the current systems of supervision in both countries in superficial terms but to take a broader view—e.g., by looking at how market regulation in Japan has developed over the years and by comparing Japan's approach to regulatory bodies with that in a number of other countries.

2. Historical Background to Current System of Supervision

1) Japan's SEC

The first point that needs to be remembered when considering how Japan's securities markets should be supervised is that Japan used to have its own SEC with all the independence and powers of the US SEC.

After the Second World War, SCAP (many of whose specialists were greatly influenced by Roosevelt's New Deal) tried to set up a number of deliberative bodies with considerable administrative powers (referred to in the United States as "independent regulatory commissions") made up of academics and practitioners. The administration of Japan's securities markets was no exception, and the prewar Stock Exchange Law was abolished and a Securities and Exchange Law enacted on the model of the US Securities Act of 1933 and the Securities and Exchange Act of 1934. Regulations were drawn up to set up a three-man Securities and Exchange Commission with its own staff and wide-ranging powers.

The Commission was set up in July 1947 and empowered to enact regulations under the Securities and Exchange Law (1948). Although the Commission was able to draw on considerable expertise and had as its chairman Shohei Tokuda, who had been president of the Japan Stock Exchange (an amalgamation of all the country's stock exchanges) during the Second World War, its very independence made it more difficult for it to communicate and cooperate with other administrative bodies.[3] The Committee was eventually wound up in August 1952 at the same time as all the other administrative bodies that had been set up by SCAP, and some of its functions were transferred to the Ministry of Finance's Securities and Exchange Council.

In the 50 years since then Japanese society and the Japanese economy have undergone a transformation. Similarly, there now exist a number of well established administrative committees which enjoy considerable independence (e.g., the National

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2 One example of this view is the May 2001 report Shihon Shijo ni Kakaru Gyosei no Arikata ni Tsuite [Regulating Japan's Capital Markets] by the Accounting Subcommittee of the Liberal Democratic Party's Financial Research Committee.

3 See Hiromi Arisawa (ed.), Nihon Shokenshi 2 [A History of Japan's Securities Markets, Vol. 2], Tokyo, 1995, pp. 92-93.

Personnel Authority and the Fair Trade Commission). However, the administration of securities markets is closely connected with many different areas of economic administration (e.g., policies concerning the financial system, policies concerning consumer protection and industrial policies) as well as with central bank monetary policy. Nor does the administration of securities markets necessarily require the degree of political neutrality needed to deal with the kind of matters that are the responsibility, for example, of the National Personnel Authority and the Election Administration Commission. It is therefore debatable whether a regulatory and supervisory agency responsible for such administrative areas should be classified as an "Article 3 administrative committee" (i.e., one governed by Article 3 of the National Government Organization Law) and completely isolated from other general administrative bodies.

Furthermore, Japan already has a Securities and Exchange Surveillance Commission to ensure that regulation of the securities markets is independent. Although not an Article 3 committee, it differs from normal administrative bodies in that it is a deliberative body the position of whose members is guaranteed. In the opinion of the chairman of the Commission, the difference between its current functions as a so-called "Article 8 committee" and those of an Article 3 committee derive from the fact that one has the power to take administrative action and to enact regulations while the other does not; but the fact that its administrative recommendations to FSA have always been acted on and that, in practice, it has been able to enact regulations by making proposals means that it does not need to be reclassified as an Article 3 committee.[4]

2) Historical background to the current system of market supervision

In this section we shall look in some detail at the events that led from the establishment of the Securities and Exchange Surveillance Commission to that of the present Financial Services Agency. This is because the present system of market supervision has emerged as the result of 10 years of debate on the subject and because any comparison with the US system and evaluation of the Japanese system that ignored this would be simplistic.

During the 40 years after the Securities and Exchange Commission was abolished the Ministry of Finance was responsible for supervising Japan's securities markets under what was jokingly referred to as the "convoy system." However, this system came in for severe criticism in 1991 when a number of scandals involving securities companies came to light. These included: the fact that securities companies had compensated some of their major corporate clients for losses; the fact that they had

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4 See Shukan Kin'yu Zaisei Jijo [Weekly Financial and Fiscal Matters], 15 October, 2001, p. 22 for the interview with the Commission's chairman, Takeo Takahashi.

conducted improper transactions with gangsters; and the fact that they had "pushed" shares in a number of companies. The conclusion was that it was improper for the authorities to be responsible for supervising the activities of securities companies as well as for investigating and punishing them for violating regulations just as it would be improper for a baseball coach to double as a referee.

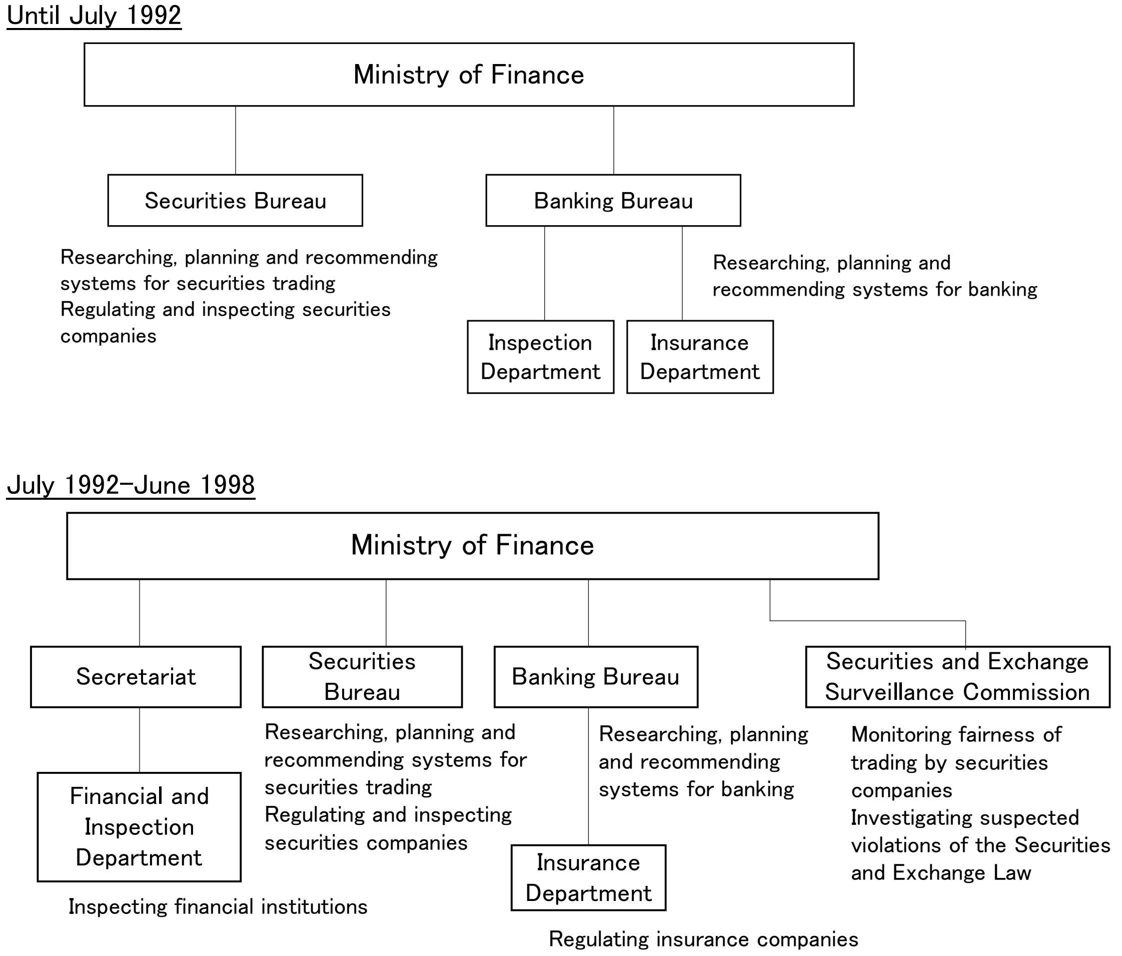
As a result, in September 1991 the Securities and Exchange Law was amended so that it became illegal to (1) compensate investors for their losses and (2) operate discretionary accounts—the practices thought to have been the immediate cause of the scandals. Next, in May 1992 the Securities and Exchange Law was amended yet again so that (1) a new supervisory body (the Securities and Exchange Surveillance Commission) was set up and (2) the powers of the bodies that regulated the securities markets were increased while a start was made on reviewing the regulations that governed the securities markets by replacing ministerial directives with laws and relying more on self-regulation.

The Commission was formed in July 1992. Unlike a normal department, the Commission is a deliberative body whose chairman and two other members are appointed by the Minister of Finance with the approval of both houses of the Diet and "exercise their functions independently." Moreover, care was taken to ensure that this independence was actually exercised by, for example, appointing a former public prosecutor as the Commission's first chairman (see Figure 1).

A few years later, in 1995, in the course of the debate on what should be done about the two credit cooperatives that collapsed and the bad loans of the housing loan companies, the Ministry of Finance had once again to face mounting criticism of the way it had supervised the country's financial system and securities markets. The final straw was when it emerged that the management of the two credit cooperatives and some senior Ministry officials had been acting in collusion, which was also, as it happened, at the same time as the Ministry found itself the subject of criticism for the way it had handled the huge losses incurred by one of Daiwa Bank's dealers at its New York branch. It was this criticism that led to calls for the Ministry to be broken up.

These calls—especially (1) for the Ministry's budgetary powers to be separated from its powers to regulate and supervise the country's financial system and securities markets and (2) for its power to approve the establishment of financial institutions to be separated from its powers to inspect and supervise them—were vehement and widespread. In February 1996 a project team was set up by the coalition government (which at that time consisted of the Liberal Democratic Party, the Social Democratic Party and the New Harbinger Party) and a serious start was made on considering how

Figure 1 System of Securities Regulation in Japan (Part I)



Source: Financial Services Agency.

to reform the Ministry and increase the Bank of Japan's independence so as to eliminate the Ministry's influence on it.

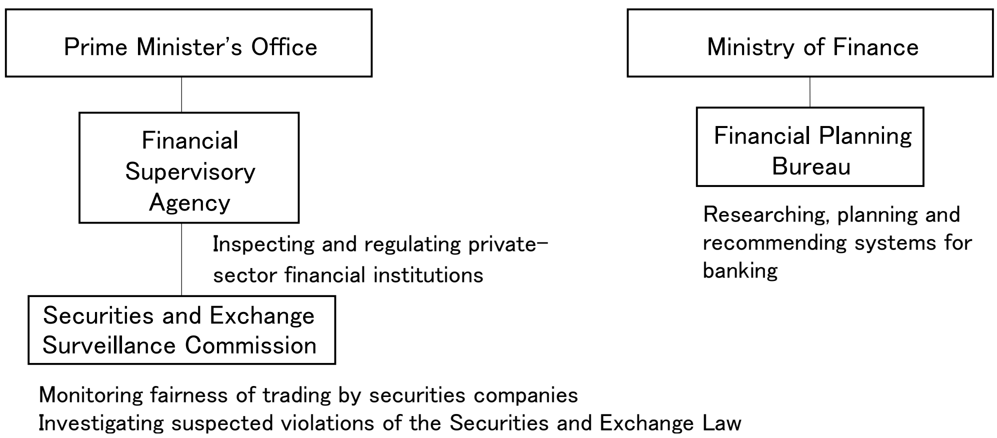
Eventually, in December 1996, the members of the coalition agreed that the Ministry's powers to inspect and supervise financial institutions should be transferred to another body but that it should be allowed to retain its power to draw up plans and proposals for the financial system. It was also decided that a new agency, the Financial Supervisory Agency, should be set up. Just as when the Securities and Exchange Surveillance Commission was set up, there were calls that the new agency should be an administrative committee with the same independence as the Fair Trade Commission. However, this proposal—just like the one that the head of the new agency should be a government minister—was not adopted.

Then, in June 1998, the Banking and Securities Bureaus of the Ministry of Finance were abolished, and the Financial Supervisory Agency was set up as an external bureau of the Prime Minister's Office. As when the Securities and Exchange Surveillance Commission was set up, the Agency's first director was a former senior judge, and a point was made of its independence from the Ministry of Finance and its desire to abandon old administrative procedures.

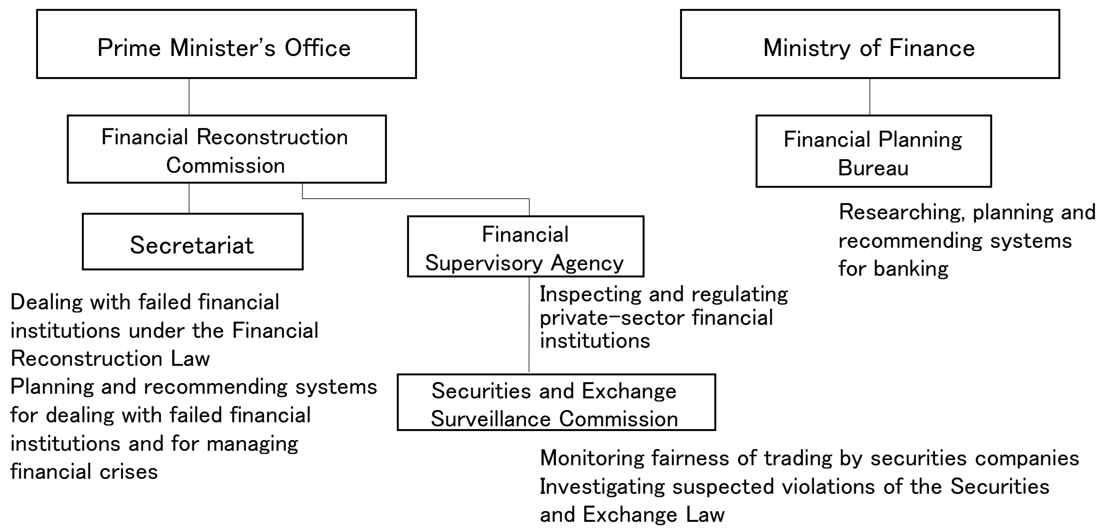
Between the time when the debate about reforming the Ministry of Finance reached a conclusion and the Financial Supervisory Agency was established the arrangements for regulating and supervising Japan's financial and securities markets underwent numerous changes, and the administrative structure (especially the Agency itself) was the subject of more reforms in a short space of time (see Figure 2).

Figure 2 System of Securities Regulation in Japan (Part II)

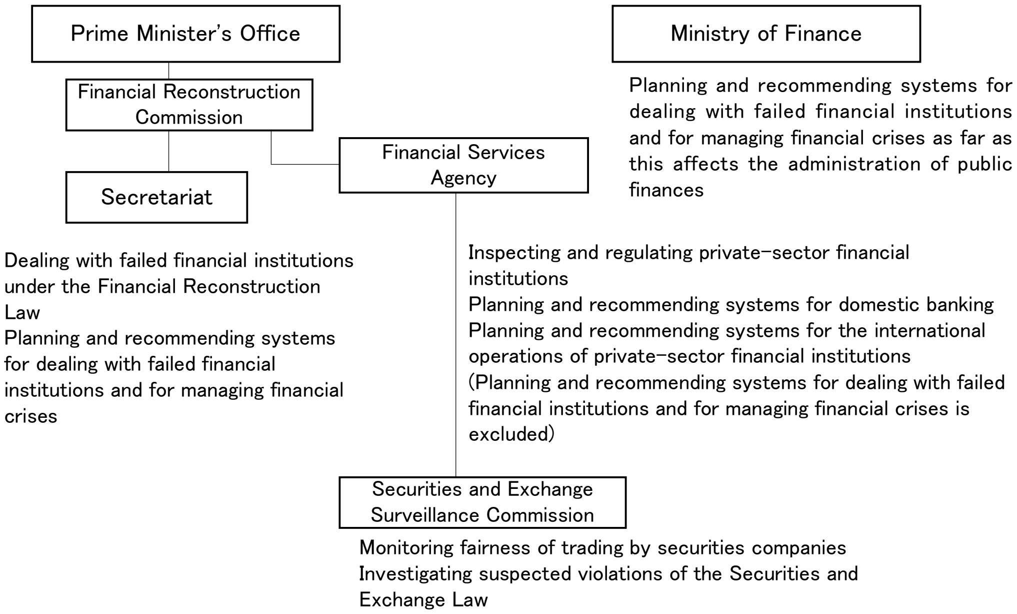
June–December 1998



December 1998–June 2000

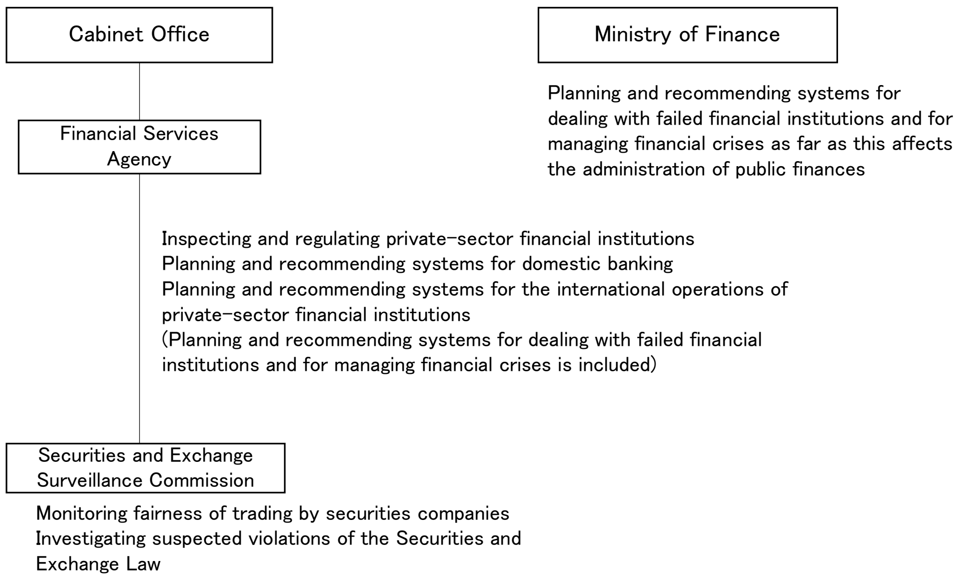


July 2000–January 2001



First, in their discussions about setting up the Financial Supervisory Agency the members of the coalition agreed that the Ministry of Finance's power to draw up plans

Since January 2001



and proposals for the financial system should be transferred to another agency as part of the efforts to reorganize central government. As a result, provisions for a Financial Services Agency to be established with all the powers needed to regulate and supervise the financial system were incorporated in the Law on Reforming Central Government, which was enacted in June 1998 (just before the Financial Supervisory Agency was officially set up).

Second, when the financial system began to come under increasing threat in November 1997 as a result of the failure of Sanyo Securities, Hokkaido Takushoku Bank and then Yamaichi Securities, two laws were enacted in February 1998 to try to stabilize the situation, and it was decided to offer financial institutions the option of receiving injections of public funds. At the same time, a Financial Crisis Management Committee was set up under one of these laws. It was decided that the Committee should include the Minister of Finance, the Governor of the Bank of Japan and councilors appointed by the government with the approval of the Diet, and that the Committee should consider applications for injections of public funds via preference shares subscribed to by the Deposit Insurance Corporation in accordance with agreed criteria.

However, this led to only small-scale injections of public funds, and the Committee was unable to stabilize the situation (e.g., because of growing concern about Long-Term Credit Bank of Japan, which continued to receive injections of public funds). In October the amount of public funds that was to be made available was therefore doubled from ¥30 trillion to ¥60 trillion; a Financial Reconstruction Law was enacted to enable alternative approaches to dealing with problem banks (including allowing any banks that failed to be brought under "special public administration" and setting up public "bridge banks"); and it was decided to set up a Financial Reconstruction Commission as an external bureau of the Prime Minister's Office to supervise the Financial Supervisory Agency.

The Commission, which was set up in December 1998, was a deliberative body responsible for drawing up plans and proposals for dealing with financial crises and failed financial institutions as well as for the mechanics of dealing with such institutions (until then the responsibility of the Financial Supervisory Agency), and was headed by a government minister. Its four members were appointed by the government with the approval of the Diet.

Third, in July 2000, the Financial Supervisory Agency and the Ministry of Finance's Financial Planning Bureau and their functions were merged to form a Financial Services Agency responsible for all aspects of regulating and supervising Japan's financial system and its securities markets. Then, in January 2001, as part of the reorganization of central government, the Financial Services Agency became an external bureau of the newly formed Cabinet Office (formerly the Prime Minister's Office). The aim of the reorganization, which reduced one office and 22 ministries or agencies to one office and 12 ministries or agencies) was to make public administration more efficient and grant the government more flexibility in policy-making. At the same time, the Financial Reconstruction Commission, which had only been set up temporarily, was abolished, and a government minister was appointed specially to supervise the Financial Services Agency.

As a result of this series of reforms, responsibility for regulating and supervising Japan's securities markets has, since January 2001, once again been that of a single government agency (the Financial Services Agency) after having temporarily been transferred. Although it is possible to take the view that this marks a return to the days when the Ministry of Finance used to have sole responsibility for regulating and supervising both Japan's financial system and its securities markets, the following points would suggest that there are certain qualitative differences.

First, the fact that the budgetary function has been separated from the function of regulating and supervising the country's financial system and securities markets means that the Financial Services Agency can carry out the latter function independently of the (newly organized) Ministry of Finance. The Agency's head is a government minister who is also a member of the cabinet. Unlike the Fair Trade Commission, for example, the Agency can negotiate with other ministries and agencies on equal terms and still retain its independence. As injecting public funds into the banks in order to stabilize the financial system has, of course, demonstrated, there are practical limits to how far ensuring the stability of the financial system (i.e., one of the objectives of regulating and supervising the system) can be separated from fiscal policy. That is why the Ministry of Finance has retained its responsibility for drawing up plans and proposals for dealing with financial crises and failed financial institutions in spite of the other reforms that have taken place.

Second, the Financial Services Agency is organized so that three different bureaus are responsible for planning, supervision and inspection alongside the Securities and Exchange Surveillance Commission, which is responsible for regulating and supervising the country's securities markets. This is to avoid the kind of conflict of interest that used to occur and which led to the Ministry of Finance being compared to a baseball coach doubling as a referee and to calls for its power to approve the establishment of financial institutions to be separated from its powers to inspect and supervise them. This is a far cry from the days when the Ministry's bureaus were organized along industry lines (Banking Bureau vs. Securities Bureau) and there was a tendency for the functions of inspection, supervision and detection within those bureaus to be regarded as of minor importance.

Third, under the Financial Services Agency there is a growing realization that the financial system and the securities markets are now being regulated and supervised more according to clear rules, violation of which will be punished, than according to the practices of the (old) Ministry of Finance's "convoy system." Indeed, some recent penalties imposed on securities companies (e.g., the order that one particular company close all its branches for a certain period) could be seen as indicating that the new approach is now actually well established.

3. Japan's Supervisory System in Comparison with That of Other Countries

If Japan's system of supervising its securities markets (i.e., by means mainly of the Financial Services Agency and the Securities and Exchange Surveillance Commission) is compared with that of countries other than the United States, it is clearly unlikely to be perceived as problematic by international standards.

One interesting object of comparison with Japan's Financial Services Agency is the United Kingdom's Financial Services Authority (FSA), the body responsible for supervising that country's financial and securities markets. The FSA is a relatively new organization, having been established in October 1997 following a reorganization of the Securities and Investments Board (SIB), the regulatory body established under the Financial Services Act of 1986, which was enacted to accompany the UK's "Big Bang" program of financial deregulation. The institutional change was not simply a change of name reflecting the fact that the law had been amended.

In other words, in addition to inheriting the SIB's responsibility for supervising the United Kingdom's securities markets and securities professionals, the FSA was given the responsibility for supervising the banking system (hitherto the responsibility of the Bank of England) and that for supervising the insurance industry (hitherto the responsibility of the Treasury). It was also decided that the FSA should assume the responsibility (previously that of the so-called "self-regulating organizations" or SROs under the SIB's mandate) for the day-to-day supervision and inspection of financial professionals. Finally, the FSA also assumed responsibility for supervising Lloyd's of London with its long history of self-regulation untrammeled by public intervention.

The financial authorities in Germany are in the process of adopting a similar system. Until now Germany has had two bodies responsible for financial regulation and supervision: the Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen), responsible for regulating and supervising the country's banks, and the Federal Securities Supervisory Office (Bundesaufsichtsamt für den Wertpapierhandel), responsible for monitoring securities trading. However, draft legislation which would merge the two bodies (in order to supervise those banks that engage in securities trading more efficiently and to improve inspection and supervision) is currently before the German parliament. [5] If this becomes law, a Bundesanstalt für

[5] This refers to the Gesetz zur Schaffung einer integrierten Finanzmarktaufsicht (Finanzdientleistungs- und Finanzmarktaufsichtsgesetz) .

Finanzdienstleistungsaufsicht (Federal Supervisory Office for Financial Services) will be established in January 2002.

Japan's system of supervising its securities markets, which regulates and supervises the banking, securities and insurance industries and is organized according to its different functions (drawing up plans and proposals for regulating and supervising the banking industry; supervising financial professionals; inspection; and monitoring markets) can therefore be said to be similar to systems found in Europe, which can easily adapt to the changes that are taking place as the financial services industry becomes dominated by conglomerates. The Financial Services Agency is also probably well aware of this. The above-mentioned Structural Reform Program calls for increased cooperation between the Inspection Bureau and the Securities and Exchange Surveillance Commission in order to deal with the growth of financial conglomerates—one example of the stricter monitoring of Japan's securities markets that it says is needed to improve the confidence of retail investors.

4. Issues Facing Securities Regulators in Japan

This is not to say that Japan's securities regulators do not face any problems.

In the United States, for example, the Securities and Exchange Commission initiates about 250 proceedings each year against the financial professionals (mainly broker-dealers) it regulates, as well as requesting the courts to issue about 200 injunctions against non-professional retail and corporate investors. In Japan, on the other hand, the Securities and Exchange Surveillance Commission only occasionally initiates criminal proceedings against those suspected of insider dealing, although it does impose penalties quite often on investment professionals (mainly securities companies) which its inspections indicate have broken the law (see Table 1). There are, of course, major differences between the US and Japanese legal systems, and it is, strictly speaking, inaccurate to compare the initiation of criminal proceedings leading to indictment by the public prosecutor in Japan with a request to a court for an injunction in the United States; but there seems little doubt that, whatever inspections and supervision the Japanese regulatory authorities carry out on securities companies and other investment professionals, their action against unfair trading practices by retail investors falls short of that taken by the SEC.

Table 1 Law-Enforcement Activities of US and Japanese Securities Regulators

		1996	1997	1998	1999	2000
SEC	Initiating administrative action	239	285	248	298	244
	Calling for an injunction	180	189	214	198	223
	Other enforcement action	34	15	15	29	36
SESC	Recommending administrative action	11	40	36	37	34
	Prosecuting criminal activity	5	7	6	7	5
	Monitoring trading	196	203	275	326	265

Source: NRI, from SEC and SESC data.

To be fair to the Securities and Exchange Surveillance Commission, it is not that it treats unfair trading practices lightly: every year it investigates a considerable number of cases where share prices rise sharply for no obvious reason and where there are large share price movements caused by the disclosure of price-sensitive information. However, there is no doubt that such investigations do not always lead to the detection of unfair trading practices. In fact, it would seem that there have been very few cases where the Commission has detected share price manipulation by corporate insiders or speculators and that it may not have done as much as it could have to deal with new types of illegal activity such as the use of the Internet to collect money fraudulently or spread rumors.[6]

Naturally, this means that Japan needs to make more resources available for supervising its securities markets. In fact, the Financial Services Agency and the Securities and Exchange Surveillance Commission want to double the number of the Commission's staff (currently 112) and plan to have a total of about 1,000 staff (including staff working for the Regional Finance Bureaus) in a few years' time. If this objective is achieved, Japan's system for supervising its securities markets will be on a par with that of the United States, given the differences in scale between the two economies and securities markets.

However, simply increasing the number of regulatory staff will not guarantee that Japan's securities markets are fair. More also needs to be done on the qualitative side—e.g., to improve the staff's specialist know-how. Also, as this report has suggested, however well equipped Japan's system of supervising its securities markets may be to deal with the global trend towards financial conglomerates, this does not mean that no institutional changes are necessary.

6 This is not to say that the Commission has ignored illegal activities on the Internet. In fact, it has shown a keen interest (e.g., by taking part in two Internet Surf Days organized by the International Organization of Securities Commissions (IOSCO)).

For example, it could be argued that the fact that the Osaka Securities Exchange was demutualized in April and that the Tokyo Stock Exchange is due to demutualize in November means that the regulatory role of stock exchanges in Japan needs to be reconsidered in the light of the trend towards demutualization and the profit motive.

Under the law as it stands, even a demutualized stock exchange is required to exercise its self-regulatory responsibility for monitoring the stock market and trading activity. In these circumstances, it would seem reasonable to assume that the Financial Services Agency and the Securities and Exchange Surveillance Commission should work even more closely with the stock exchanges' self-regulatory staff to ensure that the stock market is being supervised properly. The Osaka Securities Exchange, which has already demutualized, has itself moved in this direction by giving its self-regulatory staff more independence.

However, leaving aside the law as it stands, it could be argued that Japan's stock exchanges should hand over their self-regulatory responsibility for monitoring the stock market to a public body—as has happened in the United Kingdom, where the London Stock Exchange has handed over some of its responsibilities (e.g., that for checking whether companies satisfy listing requirements) to the Financial Services Authority.

If we just take the example of the fines which Japan's stock exchanges levy on anyone responsible for unfair trading practices, it would seem rather odd that a stock exchange that has demutualized (i.e., become a private-sector company) should impose a kind of financial penalty on another private-sector company.[7] Similarly, it may be necessary to review the role of the Japan Securities Dealers Association as a (self-)regulatory body responsible for operating securities markets in view of the increasing competition for orders and listings between its own OTC market (the JASDAQ) and both the stock markets run by the stock exchanges and the proprietary trading systems operated by securities companies.

At any rate, the debate on how Japan's securities markets should be regulated needs to be conducted in a constructive manner, seeking improvements where possible while retaining those features which have worked well. It would be a grave mistake if

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[7] This system of financial penalties can be regarded as serving the same function as the civil fines levied by the SEC in the United States. The system was probably established because of the difficulty the Japanese regulators would have faced in levying a financial penalty themselves. In fact, Japanese law demands such a system of financial penalties: "In their articles of association Securities Exchanges must make provision for levying financial penalties on members who infringe the law or regulatory decisions, or who violate the exchanges' rules of conduct" (Securities and Exchange Law, Article 87).

admiration for the work of the US Securities and Exchange Commission were to lead to ill-considered calls for the break-up of the Financial Services Agency.