Civil Fines under the Securities and Exchange Law Take Hold

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I. Introduction

With the 2004 revision to the Securities and Exchange Law (SEL), Japan introduced a new system of civil monetary penalties that went into effect in April 2005.[1] Unlike a criminal penalty, the civil fines are an administrative measure that makes violators of the law pay a monetary penalty, with the aim of preventing violations. The fines were initially assessed in cases of falsification of securities filings and other disclosure documents, the dissemination of misleading information, and the violation of rules prohibiting such unfair trading practices as fraudulent transactions, market manipulation, and insider trading.

Subsequent to that, the 2005 revision to the SEL made the falsification of ongoing disclosure documents subject to civil fines, and the Financial Instruments and Exchange Law (FIEL) passed in June 2006 (and effective April 2007) added bogus buying orders[2] issued by both securities firms and customers to the list of actions subject to the civil fines.

Below, we summarize the current status of the civil fine regime that has been fully implemented since 2006, and then consider the significance of the system's introduction.

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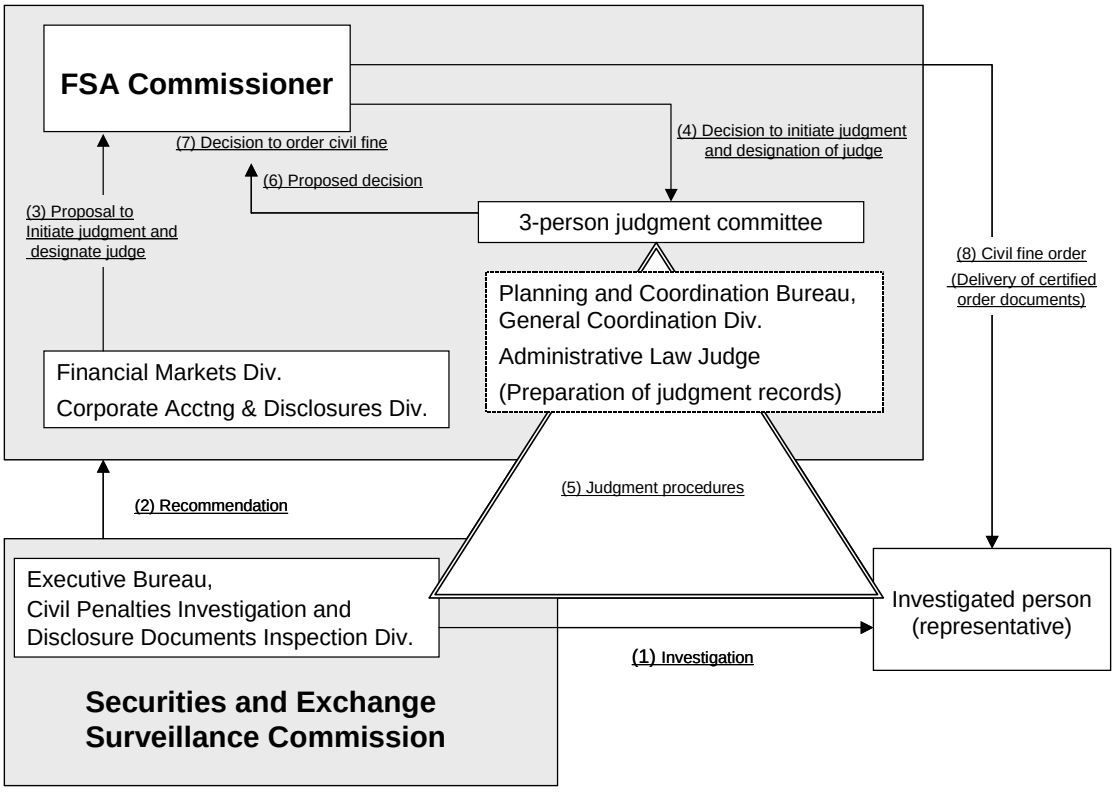
1 For more on the revised law, see Sadakazu Osaki, *Shijo no Kiban Seibi wo Hakaru Kaisei Shoutorihou no Seiritsu* (Establishing a Revised Securities and Exchange Aimed at Providing Market Infrastructure), in the Summer 2004 issue of the *Capital Market Quarterly* (in Japanese).

2 Bogus orders are fictional orders placed to make the market believe there is increased trading activity but then cancelled before they are actually executed. They are a form of market manipulation, which is prohibited by Article 159 of the Securities and Exchange Law.

Figure1 Procedures leading up to civil fine order



Source: From the Financial Services Agency website.

II. Current status of civil fine regime

1. A slew of recommendations (orders) to pay civil fines

Under the civil fine system, persons who violate the law are ordered to pay a civil fine based on the procedures outlined below (Figure 1).

When illegal activity is suspected, the SESC conducts an investigation, and if the investigation confirms that there has been a violation, the SESC recommends to the FSA Commissioner that a civil fine payment order be issued. The recommendation includes a specific monetary amount for the civil fine that must be paid. Upon receiving the recommendation, the FSA Commissioner makes the decision to initiate the judgment process, and the appointed judge puts together a proposed civil fine payment order after following the judicial process, and then submits this proposal to the Commissioner.

Although the procedures are similar to those in a court of law, in every case to date, the person subject to the civil fine payment order (the defendant) has filed defense documents indicating no objection, and the civil fine payment orders have been issued exactly as recommended by the SESC. Since January 2006, a grand total of 16 recommendations have been made for civil fine payment orders to individuals or corporations, and as of end-2006 15 payment orders had been issued (Figure 2).

Figure2 Civil fine orders and recommendations given thus far
As of end-December 2006

Date of recommendation (Date order was decided)	Subject of order	Listing market	Description of illegal activity	Amount of civil fine
13 January (8 February)	Gala (3 employees)	OSE Hercules	Insider trading	jpy310,000-320,000
1 February (15 February)	Tone Geo Tech (employee)	JASDAQ (Delisted)	Insider trading	jpy720,000
17 April (9 May)	Fujipream (corporation and employee)	JASDAQ	Insider trading	jpy420,000, jpy2.13 million
11 May (26 May)	INES (employee)	TSE-1	Insider trading	jpy50,000
24 May (9 June)	Nihon Plast (employee at client company, recipient of information)	JASDAQ	Insider trading	jpy820,000, jpy460,000
14 September (2 October)	Pao (officer at alliance partner)	TSE-2	Insider trading	jpy390,000
22 November (6 December)	Higashi Nihon House	JASDAQ	Filing of fraudulent securities report	jpy2 million
6 December (27 December)	TTG	JASDAQ (Decision to delist)	Filing of fraudulent securities registration documents	jpy131.33 million
8 December (25 December)	Aloka (employee and 2 employees at subsidiary)	TSE-1	Insider trading	jpy160,000-730,000
18 December	Nikko Cordial Group	TSE-1	Filing of fraudulent supplementary issuance registration documents	jpy500 million

Source: Compiled by author, based on materials from the Securities and Exchange Surveillance Commission

The amount of the civil fine is determined by a detailed calculation method that differs for each type of offense (pursuant to Article 172 of the SEL). In the civil fine payment order recommendation related to the Nikko Cordial group and made on 18 December, the civil fine of jpy500 million was calculated by taking 1% of the jpy50 billion bond issuance that was promoted based on falsified documents.[3]

2. Why civil fines were introduced

Civil fines were incorporated into the SEL because it was recognized that, despite aggressive efforts to encourage regular citizens to participate in securities markets under the banner of shifting funds from savings to investments, not enough was being done to rein in unfair trading practices and fraudulent disclosures in the Japanese market.

All of the conduct subject to civil fines had already been prohibited under the SEL, and nearly all were subject to criminal penalties.[4] Applying criminal penalties, however, requires indictment by a prosecutor and a trial, and in view of the limited number of prosecutors and investigative resources, the prosecutor's office is unlikely to deal with cases that do not have a substantial impact on society. The fundamental

3 Pursuant to the provisions in Article 172, Paragraph 1-1 of the Securities and Exchange Law.

4 Of the bogus orders made subject to civil fines by the June 2006 revisions, those placed by a securities firm were also made subject to criminal penalties, in addition to civil fines.

approach to criminal penalties is to use them sparingly, and the frequent assessment of such penalties is probably not desirable.

For this reason, criminal charges have been brought in a total of only 85 cases since the SESC was launched in 1992(Figure 3). In addition to bringing criminal charges, the SESC's authority to prosecute illegal conduct also includes recommending that administrative action be taken against securities firms and other registered traders. The number of such administrative actions taken for illegal conduct discovered in the process of inspecting securities firms has been so large, however, that it would be easy to take the cynical view that the authorities were merely trying to rack up points by going after the low hanging fruit.[5]

In recent years, the SESC has been making greater efforts to monitor and uncover unfair market conduct and has been more aggressive in bringing criminal charges, but they still are not bringing any more than about 10 cases per fiscal year. This is minor compared with the SEC in the US, which pursues 500 to 600 legal actions a year, including civil injunctions, barring from industry through administrative proceedings, and civil monetary penalties, and is one reason why the SESC has been criticized as being weak.

Of course, given the much greater size of US securities markets compared with those in Japan, one would expect there to be considerably more illegal conduct in the US than in Japan. There are also differences in the legal systems of the two countries, making a simple comparison between the legal actions instigated by the SEC in the US and the number of criminal cases brought by Japan's SESC quite misleading.

That said, it still makes a fairly persuasive argument to say that if the SESC were given enforcement tools equivalent to what the SEC has access to, it could be more effective in uncovering illegal behavior. It was in this context that Japan, using the aggressive system of civil monetary penalties used by the SEC as a model, has begun to implement its own system of civil fines.

Figure3 Administrative procedure recommendations and criminal charges brought by the SESC against securities firms

Administrative year (July to June of the following year)	92	93	94	95	96	97	98	99	00	01	02	03	04	05
Recommendation based on inspection results	2	12	5	9	11	36	34	37	33	25	30	25	17	29
Recommendation based on survey of criminal	0	1	0	1	0	5	2	0	1	1	0	2	1	0
Total administrative procedure recommendations	2	13	5	10	11	40	36	37	34	26	30	26	17	29
Criminal cases brought	1	1	3	1	5	7	6	7	5	7	10	10	11	11

Note: Because the number of administrative procedure recommendations includes those based upon both investigations and criminal cases, some cases are counted twice in the total numbers.
Source: Compiled by author, based on materials from the Securities and Exchange Surveillance Commission

[5] In addition, from July 2005 the SESC was vested with the authority to inspect securities filings. Based on this authority, in addition to the civil fine assessments described in the main text of this report, TTG was ordered to submit a restatement of its interim period report.

3. A growing number of cases are subject to the civil fines

The civil fine system was not applied to a single case in its first nine months after implementation, possibly because it was still viewed as a preparatory period; its first application was in an insider-trading case brought against an employee of Gala Inc. on 13 January 2006.

Cases following that in which a civil fine was recommended had all involved insider trading case until a case based on fraudulent statutory disclosures was filed against Higashi Nihon House on 22 November 2006, and the number of such disclosure cases has been increasing since then. These include fraudulent disclosure cases filed against TTG and the Nikko Cordial Group, with civil penalties in the hundreds of millions of yen.

The insider trading cases have been limited to trading initiated around the time of the announcement of material facts that have a substantial impact on the share price. If securities firms also properly classify their customers and identify the people involved, it should not be that difficult of a task to expose problematic trades.

In contrast, the filing of fraudulent statutory disclosures aimed at pulling the wool over the eyes of the auditors and CPAs can be quite difficult to detect unless the company goes bankrupt. Furthermore, it is not easy to identify a particular action as illegal without a substantial level of accounting expertise.

This broad range of cases subject to the civil fines, from the simple to the complex, could possibly be viewed as evidence that the SESC has improved its capabilities and is more confident in managing the civil fine system.

III. Assessment and outlook

In nearly every insider trading case that has been subject to civil fines thus far, the profits earned by the illegal trades have been in the neighborhood of 20,000 yen to several hundred thousand yen. This may suggest that the maliciousness of the violations has been fairly benign compared with past cases in which criminal charges have been filed.

Furthermore, the simple trading methods used in these cases suggest that trades were made on the spur of the moment and under the expectation that keeping the trades small would make getting caught unlikely. Although making a show of punishing the more serious cases to serve as a warning to others is not a bad approach, sending a strong message to the market that even the small transgressions will not go undetected is probably a more effective way to establish fairness in the market.

In parallel with its discovery of these types of cases, the SESC is also continuing to pursue criminal charges in the more serious cases, as it has done in the past. Since the beginning of 2006 and the Livedoor and Murakami Fund cases that gained worldwide infamy, the SESC has brought criminal charges in six different cases, three of which

were related to Livedoor. This number and frequency of cases is not much different than the typical year.

By steadily pursuing the traditional criminal cases in parallel with getting the civil fine system on track and starting to discover the milder infractions that would have gone undetected in the past, the SESC has been working to more thoroughly eliminate unfairness in securities markets, and it should be commended for that.

The civil fine system is thus gradually starting to produce results, although at this point its scope is considerably more limited than the equivalent mechanisms in the US. A key challenge, therefore, is to expand the system's coverage. The report on enhancing and strengthening the public accounting and auditing system issued by the Financial System Council's Subcommittee on the Certified Public Accountant System proposes implementing a system for levying civil fines on auditing firms, as well, in view of the problems that auditing firms have caused their customers (the audited firms). These problems include the recent rash of fraudulent certification and other auditor misconduct as well as the business suspension order applied to Chuo Aoyama PwC.

Although the report did not deal with the method of calculating such civil fines, assuming that the civil fines would amount in principal to forfeiture of the economic gains from illegal activity, the calculation method that is likely to be considered will probably be based in part on the auditing fees earned from the fraudulent auditor's certification.

We do not in any way think it is a good idea to aimlessly strengthen the regulation of markets. We just think it is impossible to gain the trust of investors and market participants in a market rampant with illegal activity. We would like to see the SESC, which has become adept at wielding this superior weapon of civil fines, to continue its aggressive pursuit of legal action from 2008 to increase trust in the market.