# REGULATION AND COMPLIANCE IN JAPANESE FINANCIAL INSTITUTIONS

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## I. INTRODUCTION

In January 1999, forty inspectors of the Japanese Financial Supervisory Agency ("FSA")[1] marched into the offices of the Credit Suisse First Boston ("CSFB") group in Tokyo for a surprise inspection aimed at uncovering loss-concealing transactions the group provided to its clients.[2] After six months of investigation, the FSA announced a severe final penalty to the group, including the revocation of the banking license of Credit Suisse Financial Products ("CSFP"), the group's derivatives arm.[3] The FSA's stated reasons for the sanction were CSFB's provision of window dressing transactions "extremely inappropriate from the standpoint of adequate disclosure of its clients' financial conditions," "systematic evasions and obstructions of inspections" such as shredding and hiding documents, and violation of firewall regulations. The FSA also posed administrative action to several other foreign financial institutions, including Deutsche Securities, because of window dressing transactions.

This series of administrative actions, best represented by the actions against CSFB, present an interesting issue. The administrative actions certainly demonstrate the improvement of the FSA's inspection capability, signifying one of the achievements of the ongoing financial reformation. However, more than that, what has happened between the FSA and the foreign financial institutions provides an interesting case on future relations between the FSA and Japanese financial institutions. The CSFB incident was unique since a major part of the market was reaching the same understanding on the legality of a certain product that was not consistent with the understanding of regulators. Again, this happened because communication between foreign financial institutions and financial regulators was precisely what it was supposed to be under the new financial

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1. Now called the Financial Services Agency. *See* Financial Services Agency Press Release *On the Establishment of the Financial Services Agency*, July 3, 2000. Provisional translation available at <http://www.fsa.go.jp/danwa/danwae/2000703-1e.html> (visited on March 25, 2001).

2. *See, e.g.*, Gillian Tett and Naoko Nakamae, *Japanese Agency Launches Inquiry into CSFB Operations*, FIN. TIMES, January 28, 1999, at 1.

3. *See* Statement by the Commissioner, Financial Supervisory Agency, The Government of Japan, On the Credit Suisse Group and the Kokusai Asset Management (July 29, 1999). Provisional translation available at <http://www.fsa.go.jp/p_fsa/danwa/danwae/dane-006.html> (visited on November 10, 2000); *see also* Statement by Minister Yanagisawa, Financial Reconstruction Commission, The Government of Japan, On the Credit Suisse Financial Products Bank, Tokyo Branch (July 29, 1999), provisional translation available at <http://www.fsa.go.jp/frc/newse/nc010.html>; Credit Suisse First Boston Press Release, *Credit Suisse Group is Notified of Sanctions in Japan*, July 29, 1999; *Credit Suisse Arm Loses Japan Bank License After Investigation*, FIN. TIMES, July 30, 1999, at 16; Stephanie Storm, *Japan Revokes Credit Suisse Unit's Banking License*, THE N.Y. TIMES, July 30, 1999, at 6.

regulatory structure. Unlike Japanese financial institutions that have enjoyed a close relationship with regulators, foreign financial institutions have been on their own. While Japanese financial institutions dare not provide a new product without first discussing it with regulators, foreign financial institutions (having input from legal counsel, accountants and other advisors), structured new products without it being necessary to discuss the product with the regulator. But the administrative action by the FSA was over a product developed in just such a way. The FSA has been changing its attitude toward Japanese financial institutions under a principle of "fair and transparent financial supervisory." Now that prior counseling is not always available from regulators, Japanese financial institutions must also conduct due diligence on the appropriateness of a product. In such situations, an incident similar to what happened to CSFB, Deutsche Securities, and several other foreign financial institutions may happen to Japanese financial institutions, involving an inconsistent approach to an issue between the financial regulator and financial institutions. By studying the CFSB incident, it may be possible to improve the regulatory situation, and avoid the same mistakes.

The method of enforcement of financial law in a given jurisdiction has a huge impact over how a financial institution reacts to the rules in that jurisdiction, whether in the area of compliance, or more generally. However, the method of enforcement is not the same in every jurisdiction, just as is the case for institutional compliance, where each financial institution has to develop a program that will be suitable for the institution in accordance with the culture of that institution.[4] This note will first analyze the theoretical background of financial regulation and the attitudes that should arise from that theory. It will then discuss the regulatory situation of Japan, both under the "old regime" and under the recent changes. Then, it will analyze what actually happened to CSFB and other foreign financial institutions that became subject to administrative actions. Finally, it will conclude by attempting to find the direction in which Japanese financial compliance may be heading.

4. *See* Charles J. Walsh and Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save its Soul?* 47 RUTGERS L. REV. 605, 687 (1985).

## II. REGULATION AND COMPLIANCE

### *A. Regulation and Compliance*

How should a financial regulator deal with financial institutions to make sure they are in compliance with applicable laws and regulations? What is the ideal relationship between regulators and financial institutions?

To search for an answer to this question, I would like to first ask whether a financial institution has a "duty" to comply with laws and regulations. Financial institutions certainly are required to comply with applicable rules in a financial market if they are to play in the market. However, assuming that the goal of financial regulation is to promote the stability of the financial market,[5] it is not an ethical duty posed to the institution.[6] The financial institutions, as a nexus of contracts just like other corporations, have as a mission the maximization of profits.[7] It could be said that they are allowed to choose between being in compliance with rules or being in breach of the rules and thus sanctioned, according to the likelihood of the maximization of profit. Being in breach of the rules will frequently bring additional profit to a company, and at the same time, additional cost often in the shape of fine. Thus, the institution may weigh the gain it will be able to earn and the cost it will have to pay in exchange. If the company concludes that the cost it will have to pay is less than the profit it will be able to earn, there is a highly likelihood that the company will chose to be in breach of the rule.[8]

For example, hypothesize a client that has been a good client for a securities broker for a long time, and this client has been allowing the broker

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5. *See* Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441 (1998); Speech by Thomas M. Hoenig (President, Federal Reserve Bank of Kansas City) delivered in 1996 at the World Economic Forum 1996 Annual Meeting, during the session on Rogue Traders, Risk and Regulation in the International Financial System, in Davos, Switzerland. Available at <http://www.minneapolisfed.org/pubs/region/96-12/hoenig.html> (visited on November 1, 2000).

6. *See* Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1177 n.57 (1982).

7. *See Separation of Corporate Ownership from Control*, CORPORATIONS, Sec. 2.7 (Aspen Publishers, Inc.).

8. A similar question applies to how much company management will invest in a compliance system. *See* Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76, N.C. L. REV. 1265, 1266 et. seq. A company needs to operate through employees, and it is said that company management needs to implement a compliance system to make sure that the employees acting as the company's agent are in compliance with applicable laws and regulations. Here, again, the same cost and profit will be evaluated. The management will consider the cost the company will have to pay if its employee was found to be in breach of an applicable rule, and decide how much, if any, it will invest in implementation of compliance. From this perspective, a company will be in compliance with laws and regulations if they find the fee for failure to comply is higher.

to manage its securities portfolio. The broker promises that the customer will earn a certain amount of profit, and the broker will enjoy a huge profit from the service. Suppose one year, the broker does badly in the portfolio management and not only was unable to meet the target return, but actually created a loss in the portfolio. The client, furious, tells the broker that the broker should compensate the loss, and put the broker's own cash in the portfolio to meet the target return. However, applicable law prohibits a securities broker from compensating its customer for losses incurred in regards to securities transactions, nor can the broker provide special benefits to the customer to solicit business with it. Any violation will be penalized by one million dollars. What would be the reaction of the client? If the broker was earning far more than that amount, there may be a possibility for the securities firm simply to meet the client's demands.

The cost of violation, so far, seems like it should be at a higher level. But having the highest price for every violation is not the best solution, since it will in turn cause greater harm. If the price for every breach meets the highest standard—"death" for corporations—careful attention will be paid so as not to be in breach. However, it is not always easy to operate a business without a single breach. If a nominal violation will make the company dissolve as a "cost" of doing business, the price is too high for society, since soon most of the companies will be wiped out of the world. Having an appropriate level of violation cost is the most efficient way to ensure corporate compliance with a specific rule.

### *B. Necessity of Policing*

Setting an appropriate level of cost for violations is not enough to ensure compliance. Although the possibility of not being detected may be factored into the cost, still, a breach needs to be detected in order to be sanctioned.[9] If a violation was never detected due to a lax detection process, the law will never be enforced, and the rule will be useless. Thus, there needs to be an appropriate system for detecting violations. For financial markets, this role is usually filled by financial regulation, in that a financial regulator will ensure compliance in the market. But how should this be accomplished?

I would like to discuss this issue by analogizing to a discussion of an institutional compliance program. There is a parallelism between the two

9. Easterbrook and Fischel also point out about the problem of detection. The firms should be able to justify being in breach by determining the "damages calibrated by the harm done to consumers, divided by the probability of detection." *See supra* note 6 at 1158.

"compliance" procedures, compliance with laws and regulation by financial institution ensured by financial regulator on one hand, and compliance with internal rules ensured by management of the company on the other. Just as financial institutions are responsible for making sure that their own employees are in compliance with the institution's internal rules, financial regulators are responsible for making sure that financial institutions acting in the jurisdiction they oversee are in compliance with the laws and regulations of the jurisdiction. Because of this parallelism between institutional compliance and regulatory attitudes, I believe effectiveness of regulation may be evaluated by applying the standards for institutional compliance.

There are three components for institutional compliance, who, what and how.[10] "Who" represents the organizational structure to ensure compliance, including the resource available for each organ. A specific person, usually called a compliance officer, may be designated to be in full charge of such responsibility, acting as an agent of management, or certain people may play such a role part-time. "What" is the applicable rule that needs to be made clear to enforce compliance; an identification and interpretation of laws and regulations. Also, the attitude of identification and interpretation will have a strong influence—for each rule, interpretation or application may be aggressive or conservative. "How" is the program, often called a "compliance program," that the person in charge will use to ensure that the rule identified will be followed. Such compliance programs usually consist of communication of the rule to the rest of the company, and monitoring for compliance.[11] Although the appropriate choice for each question depends on the situation and environment of each market, I would like to suggest some alternatives.

### 1. Who

The keys for the structure of compliance are fairness and resources.[12] No matter who is in charge, there will be an issue if

10. *See* John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 188. *See also* Framework for Internal Control Systems in Banking Organizations, Basle Committee on Banking Supervision September 1998, Principles for the Assessment of Internal Control Systems.

11. *See* Darryl G. Kaneko, *J.P. Morgan ga taisetsu ni surumono – reputation koso ga kinyu kikan no inochi duna* [What J.P. Morgan values – reputation is the most important for financial institutions], JYUKAN KEIRI JYOUHOU (Chuou Keizai Sha) 20 (October 20, 1998); Principles 9 and 11; Brian P. Volkman, *The Global Convergence of Bank Regulation and Standards for Compliance*, 115 BANKING L. J. 550, 587; Walsh, *supra* note 10.

12. *See* Volkman, *supra* note 11, at 587.

enforcement was unfair, in a manner that will emasculate the rule. From this principle, it makes sense that a company compliance program should have full support from the management.[13] There may be a conflict between the business group and compliance department, and the compliance department may not be able to work if the senior management supports the business group. In terms of financial regulation, however, since financial regulators usually have the authority to expel the financial institution, unlike a compliance department that usually needs the support of the management of the company to impose a sanction, this aspect seems less relevant. However, financial regulators would like to avoid unnecessary influence from the financial institution they regulate, in order to promote fair regulation. A government agency regulator, as is normal for enforcement of laws, seems to be one model of ideal regulator, in terms of both independence and fairness.

There are certain constraints that a government agency regulator faces in its operation. The first is budgetary concerns, having sufficient resources available for the regulator. Appropriate staffing, and a budget to purchase equipment and conduct training, is necessary for the regulator to operate. Under a limited budget, for a government to cover all the activities in the market is sometimes too large a burden. In such a case, making use of non-government organizations may be one solution, and would reduce the cost to government. There may be two types of non-government organizations: first, a completely non-government organization funded publicly; or second, self-regulatory organizations, funded by the financial institutions themselves. As long as both of those non-government agencies have sufficient resources and continuity, they may be good candidates to be financial regulators.

Balance and fairness is the next question. Fairness differs from situation to situation. Where there is imbalance in skill or information among market participants, there is a need for protection for one party that is subordinate in position. However, when the participants' capability and information are supposed to be equal, there is no need for such protection. All that is required is a "fair" party to judge who did what, and what the proper treatment should be. One option is a self-regulatory market, which would lighten the budgetary constraints of the governmental regulator.

Another constraint is international borders. Government regulators usually do not have authority across borders, since their power is generally

13. For example, "I stress the need for senior management support and the need to have all level of bank employees involved in compliance." Rose Mergelmeyer, quoted in *Reg. Compliance Watch* 2; available at 1995 WL 8756856 (May 1, 1995); Walsh and Pyrich, *supra* note 4, at 686.

limited to their jurisdiction. However, the financial transactions they supervise often cross international lines. If an investor in the regulator's jurisdiction was harmed by a financial institution in another jurisdiction, it is hard to chase a financial institution in that other jurisdiction. In such cases, it will be necessary for the regulator to co-operate with the regulators in other jurisdictions.[14]

### 2. What

Once the body to be in charge of compliance has been designated, that body needs to identify and interpret the applicable rules, and apply such rules to suspicious activities, in order to determine how to treat the activity. The process involves not only identifying and interpreting the law, but also setting forth appropriate regulations that will supplement the law in accordance with the situation and the practice of the market and substantiality of the activity to be regulated. It requires not only the knowledge of the applicable rules, but also knowledge of the activity to be regulated.[15] Regulators, frequently part of the government agency that was involved in making the law in the first place, are usually knowledgeable of the applicable rule. However, sometimes the regulator may not be knowledgeable of current market activity. If the regulator is not familiar with the market or activity it is going to regulate, a misinterpretation or misapplication of the law can easily result, which would make the regulation harmful rather than useful to the market.

Another important factor when the regulator is interpreting and applying the law is the attitude of the regulator. Since the law is not always specific, there is room to interpret a given rule in several ways. Although the goal of financial regulation is to promote stability of the financial market, there may be several ways to do so. Ensuring soundness of financial institutions and ensuring the fairness of the market seems to be the two core approaches. Usually, both approaches will be adopted, with some emphasis on one of the two. Attitudes in conducting such interpretation will be affected by which of the two the regulator is emphasizing. In either case, the regulator should take an attitude consistent with the situation of the market and society, and consistent across time. If the regulator takes an inconsistent

14. *See Principles for the Supervision of Banks' Foreign Establishments (the Concordat)* Basle Committee of Banking Supervisors (May 1983), which sets out how responsibilities for the supervision of cross-border banking should be shared between parent and host banking supervisory authorities. Available at <http://www.bis.org/publ/bcbsc004.htm#v3d3> (visited on April 14, 2001).

15. *See* Volkman, *supra* note 11, at 587.

attitude towards interpretation or application, it will cause confusion among market participants.

### 3. How

In light of the compliance program for institutional compliance, how to regulate should consist of communication of the rule from the regulator to the financial institutions, communication of problems from financial institutions to the regulator, and inspection by the regulator to monitor compliance. If the purpose of regulation is to detect violations and impose sanctions for them, it seems that stress should be put on inspection. The stricter the inspection, the fewer the violations. On the other hand, another strategy may be to stay close to the financial institutions, so that problems will be detected in advance, before a violation. For the purpose of the below discussion, I would like to analyze the pros and cons of each approach in detail.

#### a. An inspection-only approach

According to the above analysis, the ideal situation for compliance is where the penalty for breach is as high as it can get, and the regulator is as tough as it could be. The best attitude of the regulator to police compliance with the law, then, is to inspect financial institutions as frequently as possible. However, this is usually not the best solution. In everyday inspection situations, the cost for inspections will be also factored into the penalty. However, unlike other factors in the penalty, such as harm to the society that will not be realized until there is actually a violation, costs from inspection are already incurred, with or without an actual violation. The manpower and budget spent for the inspection do not correlate to the actual finding of the violation. If more resources spent for inspection results in no violation, that would seem to be a good thing. However, the society is still paying for the cost of inspection, which makes the approach less than ideal. The more resources spent on inspection without actual violations will mean more cost wasted.

#### b. A communication-only approach

It may be nice to have a mechanism to detect issues prior to violation. Usually, that would be done through communication between the regulator and the financial institutions. Then, how about another ideal world, in which the company always communicates with the regulator, acting in

concert with it? If there were established and reliable communication between the regulator and financial institutions, both parties would be able to reduce costs. Financial institutions would not have to pay the extreme cost for violations, and regulators would not have to devote all their resources to inspection. Breaches would occur only when both the regulator and the financial institution made a mistake and accidentally violated the law, resulting in a minimum violation cost. However, the basic problem for this situation is that it only works where a company does not have as its mission maximizing the direct benefit of the shareholders. If the reason for a corporation to exist is to provide maximum benefit to the shareholder, this situation would present an accountability issue, since the company is voluntarily giving up a chance to earn profit from a violation. If a company is willing to risk violation to maximize the profit, the regulator will not be able to expect that a company will always come and confess its sins to them.

c. Balance between inspection and communication

There thus seems to be required a good balance between inspection after the fact and communication and prior guidance in the regulatory structure. Where is the balance? It seems from the above analysis that the balance should be somewhere between the benefit the company will have to give up by taking the all-communication approach, and the cost society will have to pay by taking an all-inspection approach. Depending on the environment, there are certain situations that call for each approach. Inspection should be used when there seems to be a condition in the society, market and in the legislation itself that suggest probability of benefit by violation. The ability to inspect should always be maintained to ensure to the financial institutions that the regulator would be able to detect a violation. On the other hand, communication should be used primarily to eliminate unconscious violations. The regulator and company will be able to work together on this point. Regulators will want to detect any potential violation, and the company will want to detect breaches that will not maximize profit. Such type of violation should be detected and resolved through communication. Secondly, communication should be used to notify the company of the severity of the penalty that will be imposed on certain activity of which a company will likely want to take advantage. Conscious violations that result in serious sanctions sometimes may occur because of a misunderstanding by the company of the position of the regulator.[16]

16. Although this article began by saying that directors should consider the price of breach, it is the case that some laws will impose a sanction for conduct. On the difference between the "price"

The balance of inspection and communication will lean towards inspection where the relationship between the regulator and financial institutions is not a smooth one, and when there is a tendency for violations to lead to profit despite the cost. When there is not a smooth relationship, that is, when both parties do not trust each other, it is unlikely that there will be reliable communication between the parties unless there is a threat (that is, inspection for the financial institution) that ensures mutual honesty. Also, when it is likely to gain more profit from being in violation of the rules, there is a high possibility that a company will be in breach, so it is worth spending prior investment on inspections.

On the other hand, the balance will be leaning towards communication when there is a smooth and close relationship, and the cost of the violation is likely to be extremely high in contrast with profit from a violation. When there is a reliable relationship between the regulator and a financial institution, both will be able to communicate effectively even without the apparent threat of inspection and punishment. Also, where the cost of violation exceeds the potential profit of a violation, there is less likelihood of numerous violations, and thus, it may be better to have minimum inspections, and invest more on effectiveness of communication.

## III. REGULATION BEFORE AND DURING THE BUBBLE ECONOMY

### *A. Background*

Modern financial regulation and compliance in Japan can be divided into two stages, before the burst of bubble economy, and after the burst. For the first stage, pre-burst (until around 1990), the economy kept expanding, and Japanese financial institutions dominated the world's financial market.[17] Right before the burst of the bubble, the relationship between the regulator and financial institutions was extremely close. The financial market was run on a consensus that the regulator, financial institutions, and the rest of the country shared the fate of building companies and catching up with the "western" countries. There was minimum tension between the regulator and the financial institutions, as described above. The mechanism will be

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of violation, and "sanctions" for violation, *see* Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984).

17. According to the American Bankers Association's *International Banking Competitiveness* at 9 (March 1990), as of October 1989, the "Top 20 of the world's largest financial firms ranked by market capitalization" was dominated by Japanese financial institutions.

described in short as "reliance." The reliance was borne from a sharing of fates that took the form of the so-called "convoy" system of financial regulation. This section will review financial regulation and financial institutions' compliance before the burst of the bubble economy.

### 1. The Convoy System and Non-Competition

Japanese financial regulation was frequently described as "convoy" system, a description of a regulatory style of setting a standard that would match with the weakest member of the sector. The Ministry of Finance ("MOF") was the sole regulator in charge of the whole financial industry. The goal of the MOF was to create strong and stable financial institutions that would provide sufficient financial services to other industries, and hence contribute to the development of other industries in the country.[18] The weakest financial institution was a convoy that was protected by stronger financial institutions and the Ministry. When a financial institution failed, it was "rescued" by larger financial institutions, in a private and quiet manner. This was a benefit for the weakest, at the sacrifice of the strongest. In a market that keeps expanding, stronger institutions were able to keep growing despite the sacrifice. Larger financial institutions in such situations in effect took part in regulation. The larger banks not only took part in the governance of the smaller banks it oversaw,[19] but also had strong influence over the new legislation and regulation, creating (as a whole) a "public-private joint venture" for regulation.[20]

The convoy system was achieved also by limiting competition, both between the financial sector and within the financial sector. For limited competition between financial sectors, there was a strict law that limited participation in a financial market. There was a strict separation[21] between core banking business[22] and securities business.[23] Securities companies

18. Curtis J. Milhaupt & Geoffrey P. Miller, *Cooperation, Conflict and Convergence in Japanese Finance: Evidence from the "Jusen" Problem*, 29 LAW & POL'Y INT'L BUS. 1; Colin P.A. Jones, *Japanese Banking Reform: A Legal Analysis of Recent Developments*, 3 DUKE J. COMP. & INT'L L. 387 (1993).

19. *See* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L. J. 3 (1996).

20. *See* Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J INT'L L. 423, 452 (1994).

21. Other than a separation of the banking and securities businesses, there was a separation between long-term and short-term banking, trust banking and other forms of banking. *See* Hiroshi Kusumoto, *Kinyu seido kaikaku de kawaru ginko/shouken gyoumu [Banking/Securities Businesses Changing Under the Financial System Reformation Law]*, TOKYO KEIZAI SHINPOUSHA, May 10, 1990, at 75-105.

22. Under the Banking Law of Japan, "banking business" is defined as "the business of conducting of any of the following activities: (1) The acceptance of deposits or installment savings

were allowed to be engaged only in the businesses listed on the Securities and Exchange Law ("SEL") or approved by the Minister of Finance.[24] The SEL also restricted banks from engaging in securities business with limited exceptions.[25] Hence, each financial sector was protected from the competition of new participants. When there was a new product to be introduced in Japan, if such product was to affect other financial industries, it was introduced with the discussion of the other financial sectors. For example, in 1983, securities firms were allowed to lend money to customers for securities in a custody account, in exchange for letting banks engage in underwriting and selling Japanese Government Bonds.[26] Restriction on competition within the sector was even more restrictive. Since there was limited intra-sector competition, a hierarchy in the sector was established. Smaller institutions were protected by limiting competition within the sector. For example, interest rates were regulated such that all banks had to apply the same interest rate to deposits.[27] For the securities industry, there was a regulation fixing commissions. The interest rate was usually set relatively low, and fixed rate commission was set relatively high, so that the weakest was able to survive.[28] When such regulations were changed, the change was set forth with an effort not to make a weaker financial institution fail. When a bank asked for permission to sell a new product, the MOF instructed the bank to wait until other banks were ready to be in the same business.[29]

### 2. The Role of the Shareholder

Another characteristic that supported the convoy system was the role of the shareholder in the system. Shareholders usually have a property

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and the making of loans or the discounting of notes, or a combination of these. (2) The performance of exchange transactions." Banking Law, Article 2, Paragraph 2. Translation by Roderick H. Seeman, available at <http://www.japanlaw.com/banking/1981.htm> (visited on April 15, 2001).

23. The SEL, Article 2, Paragraph 8 (pre-amendment), defined "securities business" mainly as including a brokerage, intermediary or agency for the purchase and sale of securities, securities underwritings, or securities offerings.

24. SEL Article 43 (pre-amendment).

25. *See* SEL Article 65.

26. *See* Kusumoto, *supra* note 21, at 107-108, 110.

27. *See* K. Osugi, *Japan's Experience of Financial Deregulation Since 1984 in an International Perspective*, BIS Economic Papers No. 26 (January 1990), at 29-35.

28. *See Nikkei techou, kyou no kotoba: Kabushiki baibai itaku tesuuryou* [Nikkei Notebook, Today's Topic: Broker's Commissions on the Purcahse and Sale of Stock] (June 2000) at 9, available at <http://www.nikkei.co.jp/rcafe/today/0006/09.html> (visited on April 15, 2001).

29. *See* Tetsuya Nakano and Kaoru Yoda, OOKURASHOU KINYU KIKAKUKYOKU / KINYU KANTOKUCHOU [MINISTRY OF FINANCE FINANCIAL PLANNING BUREAU / FINANCIAL SUPERVISORY AGENCY], Takanori Sakai, ed., 1998, at 136-137.

interest in (a) the amount of dividend, (b) the rise of the share price, and (c) the company not to be in bankruptcy.[30] As for dividends, it did not matter which shares an investor held, since shareholders in Japan received only minimum fixed dividends from companies during this period. No matter how well the company was doing, the amount did not usually reflect the performance. Shareholders also were not very serious about the share price of a company. Most shareholders held their stake in a stable manner. Japanese companies were held mutually, and a majority of the shares of a Japanese company were held long-term by stable institutional shareholders.[31] Although appreciation of shares was desirable since it would provide additional security to the shareholder-company, it was not necessary in that the economy kept expanding. Although there was some fluctuation, the share price continuously rose during the period before the bursting of the bubble, and everyone expected the rise to continue into the future. In this situation, since stable shareholders kept holding the shares, they did not care too much about their appreciation. For other shareholders, the share price was expected to rise irrelevant to the well being of the financial institution itself.[32] Thus, shareholders of a financial institution cared less about the profits the institution made. Even if the shareholders did not care about profits the financial institutions earned, they did care are about companies being in bankruptcy. However, as discussed above, financial institutions were protected by the convoy system, and shareholders were almost assured by the MOF and larger banks that financial institutions would not fail. Hence, shareholders did not have to worry about economic damage from holding shares in the financial institutions.

30. "A share of stock is primarily a profit-sharing contract, a unit of interest in the corporation based on a contribution to the corporate capital. Under their share contract and by virtue of their status as owners of shares, shareholders have three classes of rights against the corporation: (1) rights as to control and management, (2) proprietary rights, and (3) remedial and ancillary rights." The shareholder rights, "designated as proprietary rights, includes: (a) the right to participate ratably in dividend distributions ...; (b) the right to participate in the distribution of assets in total or partial liquidation..." CORPORATIONS, *supra* note 7, at Sec. 13.1.

31. *See* Milhaupt, *supra* note 19, at 25. *See also* Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. INT'L. L. J. 423 (1994), at 437.

32. Most shareholders thought it so natural for share prices to keep going higher that when NTT shares decreased after its public offering, numerous shareholders made claims to the underwriter, NTT, and even the MOF. *See* Milhaupt, *supra* note 31, at 455.

### B. *The Who, What, and How of Regulation*

#### 1. Who: Government and Industry Regulators

During this period, the MOF was acting as the main regulator for the entire financial sector, covering banks, securities companies, insurance companies and moneylenders. The MOF represented the interests of the whole financial industry including banking, securities, insurance, and internal finance. There was a bureau in the MOF for each financial sector. On the other hand, the financial industry tried to realize their interests through the MOF. When the banking industry wanted to expand its product coverage into the capital markets, it did so through the MOF Banking Bureau, and the securities industry, not willing to share its market, defended its turf through the MOF Securities Bureau. Financial institutions, especially large financial institutions, also contributed to the regulation by providing information that the regulators needed, and updates on recent movements in the industry. Larger financial institutions also contributed to the financial regulation in a research and advisory function, in effect creating a "joint venture" with the MOF.

Although the MOF was the regulator for the industry, there were several other regulators as well. For the securities industry, the self-regulatory Japan Securities Dealers' Association ("JSDA") undertook part of the responsibility for regulation. It conducted registration of securities representatives pursuant to delegation from the government regulator. It also controlled the OTC securities market, and provided an industrial group for securities brokers.[33] For the banking industry, there was the Japan Bankers' Association, a non-regulatory industrial group. The MOF used both of these organizations as a tool to spread communication through the whole industry. For example, administrative guidance (as described below) was frequently distributed through these organizations. Therefore, although there was some self-regulation, it was only in cooperation with the government regulators. The Bank of Japan was responsible for maintenance of the stability of the financial market, having inspection rights over the account holders in its settlement system. The stock exchanges also were responsible for the activity on the exchange and the stability of the member institutions.

33. *See* "Article of Association of JSDA," Articles 5 and 65.

### 2. What: Laws and Regulations

The MOF was in charge of legislation as well. A well-known rule in Japan, "no-rule-means-prohibition,"[34] says that when there is no explicit law or rule that allows a certain activity or business, it means that such activity or business is not permitted in the industry. Thus, when there is a new activity or business to be introduced in the market, it is generally introduced by setting an explicit rule. The MOF was in charge of both drafting laws to be submitted to the Diet, as well as interpretation of the law enacted. The drafting of law was a process of finding a balance between different sectors in the financial industry, and interests in other areas through an advisory council (*shingikai*).[35] The product of the process usually was a compromise, reflecting everyone's interests, but especially the interest of the financial institutions likely to be affected by the new rule.

The law usually set forth a broad outline and basic principles for financial activity, and left the details to be decided by the regulator. Also, the law was drafted in a broad way so that even when there was a specific article initially intended to cover certain conduct, it could be used for other purposes as well. Thus, once a law was adopted, there could be a wide range of interpretation by the MOF. In conducting the interpretation, there was a tendency to interpret the law in favor of the financial industry. During the period, the MOF seems to have been trying to achieve a stable financial market by protecting the financial institutions,[36] and thus, less emphasis was placed on the fairness of the market. Several explanations are given for this tendency. One explanation is that after the war, the MOF protected financial institutions' interest over promoting the development of open and fair financial markets because the MOF considered important the role of financial institutions in providing sufficient funds for the industrial sector. A close relationship was built between the parties, and even after such emphasis was not needed any longer, it was too entrenched to give up easily, since it brought too many benefits to both parties.[37] Thus, it became more important to learn what the position of the MOF was regarding a specific law, rather than knowing what the law itself said. It was even said that the

34. *See* Hideki Kanda, *Japanese Capital Markets*, 12 U. PA. J. INT'L BUS. L. 569 (1991).

35. *See id.*

36. Milhaupt, *supra* note 31, at 446.

37. It has even been reported that although a inspector pointed out a potential violation in a financial institution, his superior officer in the MOF rejected the comment, and no further action was taken. *See* Taku Takizawa, in Kinyu saisei kenkyukai [Financial Revitalization Research Group], KINYU KANTOOKU CHOU [FINANCIAL SUPERVISORY AGENCY] at 60-65.

"law is an empty shell; it is ministerial ordinances, circulars and administrative guidance that have practical significance."[38]

### 3. How: Communication Becomes the Main Avenue

#### a. Communication as the main regulation

Under this environment, regulation was leaning towards being communication-driven, rather than relying on inspection. In short, this was because financial institutions' motivation to gain profit was exceeded by the motivation to avoid cost. There was almost no incentive for financial institutions to gain additional profit by being in violation of the law. As discussed above, financial institutions were free from shareholders' interests. They did not have to worry about gaining maximizing profit for the benefit of the shareholders. Therefore, the usual theory of an institution violating law in order to maximize shareholder profit ends here.

Then what was the interest that had driven financial institutions? During the postwar period, when financial institutions were expected to help fund other industries to rebuild the country, they acted as an operational branch of the MOF. The interest of the financial industry at that time was to benefit certain industries, decided by the government. After the early postwar period, during the "catch-up" stage, the financial industry had less incentive to act in such a manner. The initial goal was achieved, and the financial industry started to think about its own growth. There arose an incentive to violate the law and gain profit. However, at that time, the cost of breach exceeded the profit from the violation. The financial institutions were not willing to give up the cozy position of being protected under the convoy system. Also, under the "no-rule-means-prohibition" environment, when a financial institution wanted to expand its business, it either had to obtain an explicit rule, or gain the blessing of the MOF to interpret an existing law. If the financial institution violated the rules in the jurisdiction, but did not go so far as to lose its protection by the convoy system, the financial institution could have been treated unfavorably by the regulator in regards to other operations.[39] That was too high a cost in contrast to the possible profit that it would be able to make. Finally, especially for larger financial institutions, since they formed a joint venture with the regulator to regulate the market, the rules were basically in line with their interests.

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38. *See Dokusen okurasho kenryoku no kaitai* [*The breakup of the Ministry of Finance's "Monopoly Power"*], SHUNKAN TOYO KEIZAI [WEEKLY TOYO KEIZAI] (Sept 14, 1991) at 13, cited by Milhaupt, *supra* note 31, at 460, note 167.

39. *See* Milhaupt, *supra* note 31, at 451.

When there is almost no incentive to be in violation of a rule, at least without the blessing of the MOF, the regulator was able to lean heavily on regulation by communication. When a financial institution came to the regulator with any potential violation in an attempt to solve the problem they had, it was not efficient to spend resources for inspection. Also, financial institutions in Japan were extremely stable, that is, there were rarely newcomers being granted licenses to do business in Japan, and so, the MOF also did not have to worry about institutions that were set up especially to defraud people, gain profit, and fade away. All they had to deal with were the financial institutions that were there from the beginning and expected to be there for the long run. In such a situation, there was only a nominal inspection force. For example, the number of inspectors in the MOF, and other local financial bureaus under the MOF, was 364 in 1993.[40] In terms of frequency of inspection, regional banks were inspected once every two to three years, and large banks were inspected once every four years.[41]

### b. Methods of Communication

The methods of communications were developed, mostly as unofficial methods. One reason was that any "formal" communication in Japan became so formal so as not to be practical. Also, an unofficial method of communication was supposed to be limited, since room for interpretation was actually limited, and most core factors were decided during the official legislative process. So, for daily operation, financial regulators and financial institutions in Japan had a communication method like a web. Both parties were able to rely on the relationship between them, and on an informal method to communicate any problems. Financial institutions would communicate to the regulator to solve a problem it may have had privately, and financial regulators would communicate their private view, which financial institutions voluntarily followed. Core methods of communication included "administrative guidance" and "MOF-tan " (literally "person in charge of MOF"—see below). [42]

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40. *See Keizai Naze? Doushite!! Sonshitsu hoten shouken to ooguchi kyaku no motareai* [*Why? Why!! in economics. Loss compensation and mutual reliance relationships between securities firms and large clients*], YOMIURI SHINBUN, August 15, 1991. *See also* Interview by Henry Laurence, *The Rules of Law in the Era of Globalization, Spawning the SEC*, 6 IND. J. GLOBAL LEG. STUD. 647, 671.

41. *See* "Kinyu ni kansuru gyousei kansatsu kekka houkoku sho" ["Report on result of audit to financial administration"], Soumucho gyousei kansatsu kyoku [Ministry of Home Affairs Administrative Supervisory Division], December 1997, reprinted in supra note 29.

42. Other well known customs include *shukkou* and *amakudari*. For more on these topics, *see* Milhaupt, *supra* note 20; Gregory D. Ruback, *Master of Puppets: How Japan's Ministry of Finance*

Administrative guidance was used more frequently and more powerfully in regulating the financial market. Although administrative guidance was not a rare method of administration in the world, it is frequently suggested as one of the unique features of Japanese administration.[43] It has been observed that the significance of administrative guidance cannot be denied since "it makes the administration able to deal swiftly with demands, secure flexibility of administration, and lead to smooth achievement of administrative goals." However, "when misused, it may cause a lack of the principle of governance by law and hinder transparency of administration."[44] Administrative guidance was an efficient method of communication from the financial regulator to the financial institutions. It was an informal "view" of the MOF, so there was no need to go through the rigid procedure of formal methods of communication. Partly since it was easy to correct administrative guidance, it was possible for the regulator to communicate on a certain matter in a more timely manner, since the substance mattered more, and it was not as important to be perfect. Although laws and regulations in Japan were created to cover subject matter in a manner that was as broad as possible, administrative guidance was able to deal with one specific topic. It is suggested that as a result, most issues in Japan were dealt with by administrative guidance, in the absence of administrative action.[45]

While administrative guidance was the method for communication initiated by regulators, the financial institutions communicated with regulators through "MOF-tan." An MOF-tan is a particular employee designated to be the ombudsman to the MOF, who would pay a visit to the

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*Orchestrates its Own Reformation*, 22 FORDHAM INT'L L.J. 185 (1988); Ken Duck, *Now That The Fog Has Lifted: The Impact Of Japan's Administrative Procedures Law On The Regulation Of Industry And Market Governance*, 19 FORDHAM INT'L L.J. 1686 (1996)

43. *See*, for example, Ruback, *supra* note 42, at 194-197, 199-200; Frank K. Upham, *Privatized Regulation: Japanese Regulatory Style in Comparative And International Perspective*, 20 FORDHAM INT'L L.J. 396 (1996).

44. Report of the Third Administrative Reform Council Regarding Equipment of Fair and Transparent Administrative Procedural Legal System, quoted in Katsuya Uga, *Sheathing the Sword of Justice: Law Without Sanctions*, THEORY OF ADMINISTRATIVE PROCEDURE LAW, at 35 (1995). For example, OTC Options were not a clearly approved business eligible for securities companies to conduct, since the Securities Exchange Law specifically defined "securities business," and the only options included were "listed" options. There was a wide demand to engage in the business, and finally, the JSDA issued a rule entitled "Sale and purchase of bonds with optional rights," regarding bond transactions with an option either to deliver or cancel the transaction on a certain future date, which was economically equivalent to OTC Bond option. Since sale and purchase of bonds is clearly a securities business, OTC Bond Options of a certain kind were included as "securities business." Equity options, on the other hand, were excluded, and not allowed in the country until December 1998.

45. *See* Uga, *supra* note 44, at 35.

MOF every day to gather important information, and communicate the interest and concerns of the financial institution to the government officials. A relatively senior employee in a bank was often designated as an MOF-tan in order to match ranks with the MOF official in charge of that particular issue. Often, the MOF-tan and MOF official were classmates, or shared similar backgrounds. Hence, apart from the official communication route provided for the public, the financial institutions were able to communicate in other ways with the regulator. As was the case for administrative guidance, the MOF-tan route provided a flexible and swift method of communication.

### *C. Compliance in the Japanese Firm*

#### 1. Summary

Under the situation discussed above, there was less incentive to be in violation of the law and regulations. It could be said that financial institutions had a strong incentive to be in compliance with the rules. Under the convoy system, the cost of going against the MOF's plans was extremely high, and for smaller banks, being in violation of the law (if that was against the benefit of the larger banks), meant problems since those larger banks were usually shareholders and creditors of the smaller banks. When there was such strict separation and regulation of the businesses that a given financial institution conducted, it was extremely hard for them to be in violation of the rules without being detected, and furthermore, violation did not usually yield eventual profit.

##### a. What

Under this system, one unique feature appeared regarding the interpretation of applicable laws and regulations, which was done either through the law-making process to which the bank itself contributed, or through regulatory interpretation in the form of administrative guidance. The financial institution thus did not have to identify or interpret rules by itself. In fact, identification of a law was not a real problem, as long as the company was doing business in Japan, since there were no real new products that only one company would be selling. If there was a new product, the company was able to take part in designing the laws and regulations regarding that product, either itself or through stronger institutions in their sector, which made the company able to share an understanding of the rules with the rest of the industry and the regulator. If

there was a change of situation without a change in the law, financial institutions were able to rely on the interpretation by the MOF, presumably decided with the input of the MOF-tan handling the particular problem.

b. Who and how

Japanese firms usually had no specific "compliance department," nor specific "compliance program," as could be seen in United States firms. The circumstances were certainly ripe for implementation of a compliance program. However, there already was a system that was sufficient to ensure compliance: lifetime employment.[46] With such a system, the institutions did not consider it necessary to implement a procedure especially designed for compliance. One Japanese company president[47] described the benefit of lifetime employment:

> Once a manager of a company hired a person, he could not fire the person, unless that person committed a sin. The manager is responsible for his decision to hire the person. Thus, although it first seems that the employee lacks the ability that the manager thought he had, the manager would have to take responsibility for investing in the employee by training, and trying to make use of the employee. It will benefit the company if one out of five or six proves his ability, since that person will be able to maintain the employment of the others. The sense of security that an employee will feel, that he will be employed with the company for his whole life, will make the person work for the benefit of the company, and the manager takes it seriously to train subordinates. This makes the relationship between the employee and the company better. Since both have a feeling that they share their fate, employees will think more about the company than their wages and salary, and the company will take responsibility so that the employees will feel happy working for the company.[48]

From the employees' perspective, the cost for being in breach of the law was definitely more than the profit from the breach. One exception for lifetime employment was when the person committed a sin, that is, conduct that was embarrassing for the company. In that case, the person will be shunted off the path of promotion, and in the worst cases, fired. It meant the

46. *See* Milhaupt, *supra* note 19, at 116-117.

47. Akio Morita, Founder and Honorary Chairman of the SONY Corporation, who passed away on October 3, 1999. For more, *see* <http://www.sony.co.jp/en/SonyInfo/IR/Financial/AR/2000/Morita.html> (visited April 2, 2001).

48. Excerpt translation from Shintaro Ishihara & Akio Morita, "NO" TO IERU NIHON [THE JAPAN THAT CAN SAY "NO"] 1989, at 95-100. Translation that of the author.

person would be socially "dead." Since every company was basically adopting lifetime employment, such a person had to work under substantially worse conditions than at his previous job. On the other hand, compensation was based on seniority. The compensation and position of a person was determined on the basis of the years the person worked for the company. Even when a younger person showed more skill than an older employee, there was no change in seniority. Under such a situation, there is extremely low incentive for violation of law in pursuit of additional profit.

Hence, a financial institution relied upon implicitly and explicitly required communication between the management and the employees. As long as there was a good flow of communication, the company could be assured that there would be a compliance culture in the company; that is, its employees would be in compliance with the rules when representing the company. It also was easy to manage the knowledge the company had, since although the employees did not have a specific area that they specialized in, and instead moved from group to group from time to time, their movements were controlled by a human resources group, which ensured that sufficient knowledge was kept in each group so that the rules of business in a specific area would be transferred from one person to another through planned movement. Any irregular incident or treatment (defined broadly) was required to be approved at an appropriate level of managers. This system created a web of communication. There was no systematic monitoring system, but the company was reasonably able to rely on the communication web that a person who violated the rule would come to them.

### 2. The Daiwa Incident

During this period, there was reliance based on the sharing of fate both in the regulatory and institutional settings. Hence, the method of ensuring compliance mainly depended on communication—communication of rules from regulator or management to financial institutions or employees, and communication of problems in the reverse directions, worked without major problems. However, Japanese institutions' understanding of compliance in agreement with the regulator caused problem overseas.

In July 1995, Daiwa Bank, the 25th largest bank in the world[49] at the time, found that it suffered loss of US $1.1 billion from unauthorized trading of United States Treasury bonds in New York. A trader in New York

49. *See* Peter Grant, *Sayonara to Daiwa as Feds Lower Boom: Bank Ordered Shut for Hiding $1B loss*, DAILY NEWS (New York), November 3, 1995, at 36.

confessed to the management of the bank that he had been trading without authorization for over ten years. After confirming the facts in the trader's confession, Daiwa management went to discuss the matter with MOF officials on how to treat the incident. At the time, the MOF was having a hard time, dealing with failing financial institutions and the *jusen* problem (involving failing money-lending institutions, banks and agricultural institutions that funded those institutions, creating serious financial and political problems).[50] Thus, the officials expressed their wish that no more financial scandals should arise in the market until at least the following autumn, when the Ministry was expecting to have the issue solved. Following this advice, the bank did not report its losses to the U.S. regulator,[51] and actually submitted a false report, as if there were no loss.[52] Finally when the bank reported the facts to the Federal Reserve Board, it resulted in Daiwa's being forced to cease operation in the United States,[53] and a fine of US $340 million.[54] The case was sensational not only because of the huge amount of the loss,[55] but also since Daiwa received such a severe sanction, due to violation of the written law with the involvement of the bank's management.[56] This incident demonstrates what "compliance"

50. *See* Milhaupt & Miller, *supra* note 18.

51. *See* Sheryl WuDunn, *Japanese Delayed Letting U.S. Know of Big Bank Loss*, THE N.Y. TIMES, October 10, 1995, at 1.

52. *See* 12/1/95 Fin. Reg. Rep. 12, "Chronology of the Daiwa Affair," December 1, 1995, available at 1995 WL 9772799.

53. *See* 11/1/95 Fin. Reg. Rep. 8, "Daiwa's U.S. Operations Terminated," November 1, 1995, available at 1995 WL 9772792.

54. *See* Jacob Margolies and Debra Lau, *Daiwa Bank Pleads Guilty, to Pay $340 Million Fine*, THE DAILY YOMIURI, March 1, 1996, at 1; Peter Truell, *Daiwa Bank Admits Guilt in Cover-up*, THE N.Y. TIMES, February 29, 1996, at 1; Jay Matthews, *Daiwa Pleads Guilty, is Fined $340 million, Assessment for Cover-up May be Largest Ever*, THE WASHINGTON POST, February 29, 1996, at D10.

55. Several incidents involving financial institutions and internal control happened around that time. There was a government bond bidding scandal at Salmon Brothers, Inc. in 1991, causing four top executives, including the chairman, to resign. Kidder Peabody's lack of monitoring allowed unauthorized trading in 1991-1994. Insufficient internal control in managing derivatives sales for Bankers Trust resulted in a US $100 million settlement with a client. In 1995, Barings Bank collapsed from huge losses incurred by unauthorized trading, partially allowed by insufficient internal control. *See* Nigel Nicholson and Paul Willman, *Folly, Fantasy and Roguery: A Social Psychology of Finance Risk Disasters*, FIN. TIMES, June 13, 2000; Benjamin Weiser, *The Lessons of the Copper Caper: Big Financial Scandals Often Happen Because the Bosses Let Them*, THE WASHINGTON POST, Sept 8, 1996, at C01. Clearly, there is a need for internal control, *see, e.g.*, the Basle Committee on Banking Supervision, *Framework for Internal Control Systems in Banking Organisations*, Sept. 1998, available at <http://www.bis.org/bcbs/publ.htm> (visited on April 15, 2001), and international standards for supervision, *see, e.g.*, Kristin Leigh Case, *Recent Development: The Daiwa Wake-up Call: The Need for International Standards for Banking Supervision*, 26 GA. J. INT'L & COM. L. 215 (1996).

56. Daiwa shareholders filed a derivative suit. The district court ordered the directors to pay a total of US $775 million for failure to establish a sufficient internal compliance system, and violating United States law through gross negligence. *See Osaka chi han H12.9.20*, 1573 SHOUJI HOUMU at 4; Mark Magnier, *Japanese Court Holds Daiwa Execs Liable in N.Y. Losses*, L.A. TIMES, September 22,

meant to Japanese financial institutions. Daiwa Bank argued that under the regulation of the MOF, it was not possible for them to disclose the fact of their losses against the wishes of the MOF.[57] This argument, of course, was not persuasive to the Federal Reserve Board.

This incident underlined two situations where the Japanese style of compliance was not sufficient. The first area is where the will of the MOF was against the written law, or the MOF was indifferent with compliance with a given rule. This was especially crucial when doing business outside of Japan, out of the jurisdiction of the MOF. Daiwa Bank showed that they were not familiar with the customs of reading the law to ensure that they are in compliance without having guidance by the regulator. In response to this incident, the MOF issued a statement that it would emphasize compliance of laws and regulations by the financial institutions it regulates.[58]

The second area where the Japanese style of compliance was insufficient was when an employee was in violation with the law not to pursue additional profit, but to hide losses. Usually, when the loss was not large enough that the employee believed that the company would punish him, he would try to report that fact and make it a company issue. However, when the loss was large enough such that the employee presumably would not be able to get away with it, he would try hiding the fact, or dealing with it himself. The Japanese style of compliance was not able to deal with such a situation since it lacked an inspection process.[59] The Daiwa Bank incident triggered a new recognition of compliance in Japan.

### *D. Foreign Financial Institutions*

By 1988, 254 foreign banks were operating in Japan.[60] After the government relaxed the securities license requirement for European banks in 1985, and U.S. banks in 1987, 40 foreign securities companies set up

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2000, at 1.

57. The MOF ordered Daiwa Bank to improve its way of doing business on November 3, 1995. *See* 1405 SHOUJI HOUMU at 47; *see also Tokyo Joins U.S. in Punishing Daiwa*, THE INDEPENDENT, November 4, 1995, at 21.

58. *See* 1/1/1996 FINRR 2, "Measures to improve Banking Inspection and Supervision (Summary)," January 1, 1996, available at 1996 WL 8825548.

59. This was not a problem only for financial institutions in Japan. In June 1996, no more than a year after the Daiwa incident, the Japanese trading company Sumitomo announced that it expected to suffer a loss of $1.8 billion, equivalent to almost ten times the previous year's net profit for the company, from copper trades made by one of its executives over a ten year period. Sumitomo was known at the time for its conservative management, and the loss shocked Japan because of the company's reputation. Andrew Pollack, *A Sumitomo Loss Felt Round the World; Principles Fall Victim To Practice*, THE N.Y. TIMES, June 14, 1996, at 31.

60. *See* Osugi, *supra* note 27, at 25.

branches in Japan between 1985 and 1988.[61] The Tokyo Stock Exchange also made positions available for foreigners.[62] However, foreign banks were not able to build a presence in the market. "All the major U.S. investment banks have been in Japan for over two decades, with little to show for it."[63] Since the presence was so minor, the effect of a breach or law or regulation was not large enough to concern the regulators. Because of this minor presence, the firms enjoyed relatively relaxed regulation, especially in regards to "turf regulation."[64] While strict separation was in place between financial sectors (for example, banks were not allowed to conduct securities business even through its separate subsidiary),[65] foreign banks were allowed to create securities subsidiaries in the country to provide a full range of securities services.[66]

It could be said that there was very limited enforcement of rules in regard to foreign financial institutions. The regulator took a communication-based regulatory system approach for Japanese financial institutions, but that approach was not available for foreign financial institutions. Although administrative guidance was available through industrial groups such as the JSDA or Foreign Banker's Association,[67] the opportunities for foreigners to

61. *See Annual Report*, International Finance Bureau, MOF, reprinted in Osugi, *supra* note 27, at 25. There were four branches of foreign securities companies in Japan before 1985.

62. The number of members of the Tokyo Stock Exchange was raised from 83 to 93 in February 1986. Six out of the ten new slots were allocated to foreign financial institutions, and in May 1988, membership was increased again to 115, with 16 new seats assigned to foreign financial institutions. *See* Osugi, *supra* note 27, at 24.

63. *See* Dave Lindorff, *Open at Last! Wall Street's Firms Gain Increasing Access in Japan's New Financial Order*, INVESTMENT DEALERS DIGEST, July 5, 1999.

64. There were firewall restrictions in Japan, but they mainly functioned as turf regulations preventing banks from using their strong influence to interfere with fair competition over other industries. *See* Masaki Yagyu, *Securities Activities of Japanese Banks Under the 1993 Japanese Financial System Reform*, 15 J. INTL. BUS. 303, 370 (1994), note 401. For foreign financial institutions, the firewall was applicable only between banks and securities firms that had more than 51% of a capital relationship. *See* Foreign Securities Company Law, Law No. 5 of 1971. Thus, it was possible to avoid being subject to the law by having a silent partner.

65. *See* Yagyu, *supra* note 64, at 370.

66. In 1985, the MOF allowed two banks to establish securities subsidiaries in Japan if the bank had less than 50% interest in the securities subsidiary. By 1988, 22 foreign banks established a securities subsidiary in Japan. *See* MOF International Finance Bureau Annual Report 1989 reprinted in Kusumoto, *supra* note 21, at 133. A similar situation existed for trust banking. Japanese banks were basically not allowed to conduct trust banking in Japan. "It is our general principle not to approve trust business to be conducted by banks." *See Kuragin dai 5133 gou* [Ministerial Order from the banking bureau No. 5133], Article 4, Paragraph 2 (December 25, 1963), reprinted in Kusumoto, *supra* note 21, at 96. However, foreign banks were allowed to do so, if they established a trust bank in Japan. Pursuant to this regulation, nine trust banks were given approval in 1985.

67. Foreign banks were not able to become a member of Zenginkyo until April 1999. *See* Mainichi Interactive, *Kinyu gyoukai: zenkoku ginkou kyukai ga hossoku, 21 Seiki e system kouchiku mezasu [Financial Industry: Japanese Banker's Association Inaugurated, Aiming for Establishing a System Towards the 21st Century]*, April 20, 1999, available at Mainichi Interactive homepage,

participate in the lawmaking process through informal communication with the regulator were extremely limited. Also, they did not have employees with connection to MOF officials, or even if they did, they could not justify having one person on staff whose responsibility was to visit the MOF everyday. So foreign banks did not have an MOF-tan as the Japanese financial institutions had. Since the firms were not protected by the convoy system, and the presence was minor for the foreign financial institutions, the regulators (with minimum resources for inspection) did not expend resources to inspect foreign financial institutions.[68] With no fear that violation would be caught by inspections, there was almost no incentive for foreign financial institutions to discuss potential violations with regulators.

Regulators, presumably, were relying partly on the rule that no product is allowed without a specific law or relegation that permits the product. However, the foreign financial institutions read the rule in the opposite way. It was their understanding that conduct should be permitted absent a specific prohibition. With no fear of being caught, some firms interpreted the rules in an extremely aggressive way. It was frequently the case that foreign financial institutions had only limited resource for compliance in their branches in Japan.[69] The standard for compliance of foreign financial institutions in Japan was low from the MOF's perspective. There was frequently no compliance in line with the implicit understanding between the financial regulators and the Japanese financial institutions.

## IV. REGULATION AFTER THE BUBBLE ECONOMY

### *A. Change in Circumstances and Reform*

#### 1. The Keizai Hakusho (Economic White Paper)

In November 1996, Prime Minister Ryutaro Hashimoto stated in his general policy speech that a reformation of the financial and social systems of the country was necessary to meet the new century. He especially

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<http://www.mainichi.co.jp/news/selection/news01.html> (visited on April 16, 2001). In April, two foreign banks became members, and 20 became associate members. *See Press Conference of Sugita Chairman*, Zenginkyo (April 20, 1999), available at <http://www.zenginkyo.or.jp/news/newskaiken04.htm> (visited on April 16, 2001).

68. It was reported that "88 foreign banks and about 60 foreign brokerages are operating in Japan, and many have never been searched." *FSA to Monitor Foreign Firms*, ASAHI SHINBUN, May 28, 1999.

69. *See A Little Local Difficulty in Japan: As Tokyo's Financial Regulators Try to Impose Higher Standards, They Are Causing Confusion and Resentment*, FIN. TIMES, June 23, 2000, at 15.

emphasized five reforms, including administrative reform and financial system reform, targeting execution by 2001.[70] For the financial system reformation, or "Japanese big bang," the creation of a "free, fair and global" market was defined to be the base principles of broad market reform. The main purpose was to liberalize financial products in Japan and raise the Japanese financial market to the same level as London and New York.[71] The reform was in response to the recession and criticism that the "post-war" Japanese economic system was no longer appropriate to the needs of Japanese society. The Keizai Hakusho, published in July 1996 (the 50th paper after World War II), pointed out that to reform the "catch-up" style economy to a "post-catch up" style economy, there needed to be a change in the system that defined the Japanese market economy.[72]

Keizai Hakusho is an economic white paper issued annually by the Economic Planning Agency of Japan. It is best known for its declaration of 1956, in which it said Japan's economy "is not 'post-war' any more."[73] The phrase became the most popular phrase of the year, not common for phrases in recent administrative papers. It was later criticized as just the scribblings of a bureaucrat, but it still offers a concise explanation of the movement of the Japanese economy, and offers an interesting description and point for modern-day analogies.[74] I would like first to review the changes in the

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70. *See Dai 139 kai kokkai niokeru Hashimoto naikaku souridaijin shoshin hyoumei enzetsu [General Policy Speech of Prime Minister Hashimoto given at the 139th Diet]*, November 29, 1996, available at <http://www1.kantei.go.jp/jp/shoshin-1129.html> (visited on April 15, 2001); *see also Editorial: Nation needs "winds of reform,"* THE DAILY YOMIURI, November 30, 1996, at 6.

71. Ministry of Finance, *Financial System Reform – Toward the Early Achievement of Reform*, June 13, 1997, available in English at <http://www.mof.go.jp/english/big-bang/ebb32.htm> (visited on May 15, 2001). "Free" in the paper is defined as a liberal market under market principles, a fair, transparent and reliable market, and a global, international and advanced market. It was stressed that Japan is being isolated from the rest of the world, and its market is falling far behind other major markets of the world such as financial markets in London and New York, and Japanese financial institutions are behind their competitors in other markets in the products they are providing. The ratio of shares traded in Tokyo as to globally went down from 54.6% in 1989 (London 10.7%, NY 34.7%) to 14.7% (London 21.7% NY 63.6%) in 1996. *See* Tokyo Stock Exchange figures cited in Akiko Otsuka, "Nihon no kabushiki shijyou no kouzou henka" ["Structural Changes in Japan's Stockmarket"], *Yusei kenkyujyo geppou 1999.3 [Institute for Posts and Telecommunications Policy (IPTP) Center Monthly Report, March 1999]* at §2.3, available at <http://www.iptp.go.jp/research//f_index.html > (visited May 19, 2001).

72. The Keizai Hakusho published in July 1996 pointed out that to reform the "catch-up" style economy to a "post-catch up" style economy, there needs to be a change in the very system that defines the Japanese market economy. *See* Economic Planning Agency, *H8 Annual Economic Report* under the subtitle "Reformation will carve a way of prospects," July 1996. Available at <http://www5.cao.go.jp/j-j/doc/point8-j-j.html> (visited on April 6, 2001).

73. THE SANKEI SHINBUN Internet Edition, July 25, 2000, available at <http://www.sankei.co.jp/databox/paper/0007/25/main.html> (visited on April 7, 2001).

74. *See* Tsutsuya Chikushi, "Mohaya hakusho de wa nai?" ["Radical White Paper"], *News 23 Taji souron [News 23 Today's Column]*, News broadcast on July 26, 1996, available at

Japanese economy described by the Keizai Hakusho subtitled "Challenge to Economical Revitalization" issued in July 1999. That document explains the history from the bubble economy to the recession as follows:[75]

> [I]n fiscal 1989, the Japanese economy seemed to be in its best condition. Company profit was at the highest in history, bankruptcy was at the lowest in recent years, and stock prices and land prices kept going up. Japanese companies purchased real estate and overseas companies with low-cost funds, and the Japanese style of company management was described as "invincible." At the end of the 1980s, share prices and land prices formed a "bubble." Share prices had their peak at the end of 1989, sharply fell from the beginning of 1990,[76] and were followed by land prices, causing a major recession, that is, the bursting of the bubble.[77] After a short break from 1995 to 1996, the economy started to decline again after March 1997,[78] when open seams began to be revealed. The first was a tremendous amount of bad loans by financial institutions.
>
> Due to decline of real estate prices, borrowers incurred huge losses that resulted in a tremendous amount of bad debt held by the financial institutions. Because of this, the capital ratios of financial institutions decreased seriously, and some of the major banks had to retire from international business, because they could not maintain the required capital ratio of 8%. Some regional banks ended up with capital ratios of less than the 4% required as the standard of healthiness for banks in domestic business. In November 1997, Yamaichi Securities, found to be engaged in loss-concealment by "*tobashi*" (transferring depreciated assets quietly to other entities), failed, as did Hokkaido Takushoku Bank, with its problems in evaluating credit. Although there was no chain panic, since deposits were fully protected until March 2001, this was the first full-scale crisis for the Japanese financial industry. In response to the crisis, the government injected JPY 1815.6 billion to 21 main financial

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<http://www.tbs.co.jp/news23/taji/s60726.html> (visited on April 5, 2001).

75. Taichi Sakaiya, *On the Publication of the Annual Economic Planning Agency White Paper of Fiscal 1999: Challenge to Economical Revival*, ECONOMIC PLANNING AGENCY, July 16, 1999, available at <http://www5.cao.go.jp/j-j/wp/wp-je99/wp-je99-000m1.html> (visited on April 6, 2001). This translation, by the author, is not a word-for-word translation, but rather the gist of the White Paper.

76. The Nikkei average was almost JPY 38,915 at the peak of bubble economy at the end of 1989. There was a sharp drop in 1990, and went below JPY 20,000 in 1991 for the first time in five years. *See* Otsuka, *supra* note 71, at §2.3. Footnote that of the author.

77. On the bubble economy, *see, e.g.*, Geoffrey P. Miller, *The Decline of the Nation State and its Effect on Constitutional and International Economic Law: The Role of a Central Bank in a Bubble Economy*, 18 CARDOZO L. REV. 1053 (1996). Footnote that of the author.

78. At the end of 1997, the price went down to JPY 13,842, almost one third of the price in 1989. *See* TSE and BOJ data in Otsuka, *supra* note 71, at §2.3. Footnote that of the author.

institutions in March 1998. Also, the government started strict inspection and supervision by setting up the new Financial Supervisory Agency in June 1996. Financial institutions, for their part, wrote off bad loans, and also made an effort to improve capital ratio by compressing gross assets, the denominator of the ratio. This became the so-called "kashi shiburi" (grudge loans). This caused a liquidity crisis in the Japanese economy. From spring to fall 1998, the Japanese economy was in a crisis situation, since the liquid that is equivalent with the blood of an economy was not able to circulate, because of the non-functioning of the financial institutions that are equivalent to the heart. In fiscal 1998, the Japanese economy tumbled into recession, with major demand categories being down from the previous year, and most businesses suffering from declines in profit and income.

### 2. The End of Financial Prosperity

#### a. End of the convoy system

When the economy stopped its remarkable expansion, financial institutions were not able to profit without effort. Even the strongest financial institutions had to struggle to survive. Together with the push from outside the country to liberalize the market, competition started to be introduced in the Japanese financial market, first within the financial sector. Once competition was introduced, financial institutions started to lobby the MOF for access to other sectors. It was said that the money would flow from the loan market maintained by the banks to the securities markets of the securities companies. Banks wanted to be in the securities market, and securities firms wanted to offer loan and deposit products. Gradually competition was introduced in the market, and as a natural consequence (and also due to the recession), financial institutions started to fail. By then, neither the regulators nor the larger financial institutions were willing or able to protect the convoy anymore.

Introduction of competition within the financial sector started to be discussed as early as the 1980s.[79] In 1984, the MOF announced a report regarding deregulation and globalization of economy. It approved short-term deposits bearing money market interest to certain categories of financial institutions.[80] Interest rates for all term deposits were liberalized in June

79. The reason for the introduction was said to be pressure from the U.S. government (in the context of the Japan-U.S. working group yen/dollar working party), and over-issuance of Japanese government bonds by the MOF. *See* Milhaupt, *supra* note 31, at 448.

80. The deposit is the so-called Money Market Certificate (MMC), approved for Sougo Bank and Credit Union to make available to clients. *See* Osugi, *supra* note 27, at 29-30.

1993, followed by savings accounts in October 1994, which completed the deregulation of interest rates. Deregulation for the securities industry occurred around the same time. In 1994, fixed commissions for securities firms started to be abolished. Deregulation of fixed commissions by securities brokerages started by liberalizing commissions for large-amount transactions.[81] Followed by another interim lift, regulation of such commissions was completely eliminated in 1999.[82] As a result, profit from commissions decreased from 57.2% in 1989 to 34.7% in 1998.[83]

Competition among the financial sectors was introduced as well. In 1991, the Financial System Research Council recommended the abolition of barriers between certain types of banks, and between banks and securities companies.[84] A proposal was made for the introduction of competition in Japanese financial markets and for competition between banks and securities companies in Japan. Securities industries were gradually allowed to provide products similar to banking products. In the 1980s, they were first allowed to extend loans when a customer had securities in the securities firm's custody account, and allowed to act as a broker for Certificates of Deposit.[85] In 1992, securities firms started to provide Money Market Funds.[86] The product is a fund investing in debt securities and other short-term instruments, and unlike other funds available at the time, they allowed withdrawal of money usually on the same day. In October 1997, securities firms were allowed to provide Money Reserve Funds. The funds enabled a customer to put cash into the fund that would be invested only in securities with high credit ratings, and the investor would be able to use the cash for other securities transaction, or even payment of gas or electricity bills. It could even accept direct deposits of salary, just like bank deposits.

Banks were even keener on eliminating separation between financial sectors, since loans and deposits were declining.[87] First, in the 1980s, banks were allowed to engage in underwriting and selling Japanese government bonds.[88] The enforcement of the financial system reformation law in 1993 was a landmark for banks starting to be engaged in the securities business.[89]

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81. *See* Otsuka, *supra* note 71, at §9.

82. *See id.* at §3.

83. *See id.* at §4.

84. *See* Ian Rodger, *Factions Line Up To Test The Barriers, Japanese Financial Liberalisation is Getting Back into its Stride*, FIN. TIMES, December 3, 1987, at 36.

85. *See* Kusumoto, *supra* note 21, at 110-113.

86. *See* Otsuka, *supra* note 71, at §8.

87. *See* Milhaupt, *supra* note 31, at 443.

88. *See* Kusumoto, *supra* note 21, at 107-108. This was in exchange for letting securities companies lend money to customer for securities in custody account. *Id.* at 110.

89. *Law Concerning the Realignment of Relevant Laws for the Reform of the Financial System and the Securities Trading System*, Law No. 87 of 1993. For more on this, *see* Brian Arthur Pomper,

The law was not drastic enough to make any practical difference, since although the law permitted banks to have securities subsidiaries, such subsidiaries were not able to provide an equity business. However, the reform did have symbolic meaning: the end of turf protection. In 1999, banks' securities subsidiaries became able to provide such equity business.[90] In 2000, regulators announced guidelines on licensing and supervision of new types of banking business including corporate-owned banks, in effect allowing such type of bank ownership.[91]

Although competition was introduced, it was first done in a mild way, in order to not cause failure as a result. So, it still was believed that financial institutions would not fail in Japan. Large firms were morally committed to take responsibility of the smaller financial firms. However, the convoy system started to collapse soon after the burst of the bubble economy. Financial institutions started to collapse from late 1994: two credit unions in Tokyo, Tokyo Kyowa and Anzen Shinyou Kumiai, collapsed that year.[92] Their assets were transferred to a bank newly created by the government, Tokyo Kyodo Bank.[93] The regulator tried to make the larger banks that had dealings with the failed institutions share the burden of losses. However, the banks this time strongly resisted the convoy method solution.[94] There was no rescue by merger with other healthy institutions, for the first time since 1927.[95] The governor of the Bank of Japan is reported

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*The Japanese Financial Reform of 1993: Will Reform Spark Innovation?*, 28 CORNELL INT'L L.J. 525 (1995).

90. *See Nikkei techo – yasashi keizai yougo no kaisetsu – kyou no kotoba 2. "Shouken kogaisha no gyoumu hani kisei"* [*Nikkei Handbook – easy to understand explanation of financial terms – word of the day 2. "Limitation of securities subsidiaries"*], August 1999, available at <http://www.nikkei.co.jp/rcafe/today/9908/02.html> (visited on April 15, 2001).

91. *See The Financial Reconstruction Commission/Financial Services Agency Press Release Measures for Licensing for and Supervision of New Types of Banks (Operational Guidelines)*, August 3, 2000, provisional translation available at <http://www.fsa.go.jp/news/newse.html> (visited on April 15, 2001). *See also* Anthony Rowley, *Sunny Days for Internet Banking in Japan*, THE BUS. TIMES (Singapore), February 8, 2001, at 10; Charles Smith, *Sony Leads Japan Into Online Banking: Financial Sector Faces Challenge from Outsider*, SUNDAY BUSINESS, April 2, 2000.

92. *See* Paul Blustein, *Bailout of Credit Unions Breaks Ground in Japan*, THE WASHINGTON POST, December 10, 1994; Michiyo Nakamoto, *Ailing Japanese Banks Throw a Lifeline: Credit Unions Pushed Close to Bankruptcy by Lending to Troubled Property Group*, FIN. TIMES, December 10, 1994, at 4.

93. *See* Nakamoto, *supra* note 92, at 4; *Tokyo Kyodo Bank Opens*, THE DAILY YOMIURI, March 21, 1995 at 8; *Bailout Bank Starts Operations*, MAINICHI DAILY NEWS, March 21, 1995, at 1.

94. *See* Emiko Terazono, *Credit Union Fallout Perturbs Japan's Banks: Large Institutions are Wary of Playing a Big Role in Bailouts*, FIN. TIMES, September 4, 1995, at 4.

95. In 1927, "the government and private sector launched the jointly owned Showa Bank to take over the assets of failed financial institutions during the slump of that time. Showa, unlike the new vehicle, was privately funded, with the central bank simply co-ordinating the rescue." William Dawkins, *Officials Break with Tradition to Reassure Financial System*, FIN. TIMES, December 10, 1994, at 4.

to have stated at the bank's internal meeting, "Failure of an institution that has reason to fail is necessary from the viewpoint of nurturing a sound financial system built on competitive mechanisms."[96] Followed by several other regional banks and credit unions from 1995 to 1997,[97] in late 1997, Hokkaido Takushoku Bank, one of the largest banks in Japan, and Yamaichi Securities, one of the "Big Four" securities firms of Japan, collapsed.[98] In late 1998, Long Term Credit Bank and Nippon Credit Bank were temporarily nationalized, as they were found to be insolvent after inspection by the Financial Services Agency.[99] It became evident that there would be no "assurance" that a financial institution would not collapse in Japan any more.[100]

Under the new system, it became necessary for financial institutions to compete with others, and thus to plan and strive to gain profit. It also

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96. *Id.*

97. "December 12, 1994: Tokyo Kyowa Credit Union and Anzen Credit Union collapse and move operations to a newly created government-sponsored bank, Tokyo Kyodou Bank.

- July 1995: Cosmo Credit goes under, operations replaced by Tokyo Kyodou Bank.
- August 1995: Kizu Credit Union goes bust. Resolution and Collection Bank, an entity transformed from Tokyo Kyodou Bank, inherits its operations.
- August 1995: Hyogo Bank, a regional bank, fails with its operations replaced by newly formed Midori Bank.
- December 1995: Osaka Credit Union fails. Operations taken over by Tokai Bank.
- March 1996: Collapse of Taiheiyo Bank, a second-tier regional bank. Wakashio Bank later created to take over its operations.
- November 1996: Hanwa Bank, a regional bank, bankrupt. Kii Yokin Kanri Bank formed to absorb its operations.
- April 1997: Nissan Mutual Life Insurance ordered to end business operations. Existing policy contracts taken over by newly created Aoba Life Insurance.
- May 1997: Ogawa Securities, a smaller brokerage, files for voluntary closure.
- October 1997: Kyoto Kyoei Bank, a regional bank, collapses with operations to be shifted to another regional bank, Kofuku Bank.
- November 3, 1997: Sanyo Securities, a second-tier brokerage, files for bankruptcy.
- November 17, 1997: Hokkaido Takushoku Bank goes under with operations taken over by North Pacific Bank."

Gillian Tett, *Scandals and Market Forces Unseat Yamaichi*, FIN. TIMES, November 24, 1997, at 2.

98. *See Japanese Giant Goes Bust*, DAILY MAIL, November 22, 1997, at 2; Gillian Tett, *Yamaichi Looks Close to Collapse Japan's Fourth-Largest Securities Broker Reported to Have Decided to Liquidate Itself*, FIN. TIMES, November 22, 1997, at 1; *Hokkaido Takushoku Collapses Under Bad Loans*, MAINICHI DAILY NEWS, November 18, 1997, at 1; Stephanie Storm, *Bailing Out of the Bailout Game: Tokyo Does the Unthinkable and Lets a Big Bank Fail*, THE N.Y. TIMES, November 18, 1997, at 1.

99. LTCB and NCB were temporarily nationalized at the end of 1998, pursuant to the Financial Revitalization Law Article 36. LTCB was then sold to Ripplewood, a U.S. private equity group. *See Ripplewood Chosen as Buyer for LTCB*, THE DAILY YOMIURI (Tokyo), Sept. 29, 1999, at 1. NCB was sold to financial alliance consisted by Softbank. *See Cleaning Up NCB Mess*, MAINICHI DAILY NEWS, February 27, 2000, at 2.

100. *See* FSA, *Final Report of the Working Group on Financial Inspection Manuals*, April 8, 1999, provisional translation, at 12. Available at <http://www.fsa.go.jp/p_fsa/news/mewse/ne_012a.html> (visited on November 10, 2000).

became evident that if financial institutions could not earn profit, or had too many losses, they would have to fold.[101]

b. Shareholders' interest in the performance of the financial institutions

The interests of the shareholders started to change during this period. The traditional situation of Japanese companies constantly paying modest dividends compared to companies in other country was criticized as a problem of management. Although there still is a strong tendency for companies to adopt a policy yielding stable dividends,[102] some companies have started to announce dividends pursuant to the amount of profit earned.[103] The market has changed as well. After the recession, it was not the case any more to have high share prices effortlessly. Companies with problems in management suffered weak share prices. Cross-shareholding started to unwind at the same time the economy slowed down, which caused more fluctuation of share prices.[104] Finally, as the convoy system fell, the market started to worry that a financial institution may, in the worst case, go bankrupt. This fear led to withdrawals of investment from certain financial institutions, punishing such institutions based on the suspicion that they were not earning enough profit, or, in some cases, were going bankrupt. It was shocking that major financial institutions had to close since they were not able to get short-term funding to mitigate their falling share price.[105] The securities market and the shareholder started to show greater interest in the performance of financial institutions.

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101. *See* Gillian Tett, *Better Late than Never*, FIN. TIMES, December 15, 1998, at 22; Gillian Tett, *NCB Lets Decorum Slip as Government Gets Tough: The Japan Bank is Angry at the Assessment of its Bad Loans as it Faces Nationalisation*, FIN. TIMES, December 14, 1998, at 21.

102. *See* website of the Tokyo Stock Exchange, <http://www.tse.or.jp/data/examination/dividend_h11.html> (visited on April 9, 2001).

103. *See* Interview with Masashi Kaneko (President, Nikko Securities), *Kikan gyouseki shugi no haitou tettei [Dividend Payment Policy Pursuant to the Business of the Period]* ASAHI SHINBUN, available at <http://www.asahi.com/market/file/19991123.html> (visited on April 9, 2001).

104. The TSE reports that cross-shareholding by banks was cancelled in 1998. *See* Tokyo Stock Exchange, *Kabushiki mochiai no saikin no doukou*, Sept 16, 1999, available at <http://www.tse.or.jp/data/examination/report/index.html> (visited on April 9, 2001); 1575 SHOUJI HOUMU.

105. *See Japan Business Finally Discovers Market Forces*, THE DAILY YOMIURI, December 9, 1997, at 12.

### B. *Changes in Regulation*

During the prosperity of the bubble economy, the Japanese style of delicate and complicated regulation and institutional compliance was appraised as a reason that Japan was "number one." Once the bubble burst, however, it became clear that there was a major problem in the country's financial system:

> [Before Daiwa's trouble] came a string of smaller but significant losses by other banks and financial concerns in New York and other international markets, not to mention combined losses of more than $30 billion by Japan's 21 biggest banks in the fiscal year that ended in March. ... Some of the losses have been caused by fraud, others by sheer bad management, other simply by an inability to cope with the complexities of modern financial markets. But the simple math is that Japanese financial and management systems are not sophisticated enough for the late 20th century.... The ministry of finance exercised iron control over financial markets, but not normally through clear-cut laws. Instead, it operates largely by administrative guidance and sometimes through nods and winks. This system, essentially one of trust and an old-boy's network, worked decades ago. But it does not work today.[106]

The post-bubble period was a time to cast off the old system and old method. As the prior "sharing fate" type of regulatory regime represented by the "convoy" system and lifetime employment collapsed, there was an effort to change the financial regulation system to one that better met the needs of the economy, and institutional compliance tried to make such changes as well. This section will review what has changed, and in what manner.

#### 1. Changes in Who

The reformation of the MOF progressed in terms of its regulatory powers. First, to strengthen the inspection capability of the regulators, a separate body, the Securities and Exchange Surveillance Commission ("SESC"), was created under the MOF. Then, in response to growing criticism of the MOF as the guardian of the financial sector, a new regulator, the Financial Supervisory Agency ("FSA"), was established to be the

106. Kevin Rafferty, *Japanese Losses Raise Doubts Over Financial Sophistication: Sumitomo's Copper-trading Trouble is Only Latest in a Series of Scandals*, THE CHRISTIAN SCIENCE MONITOR, June 19, 1996 at 8.

guardian of the market, and of investors. Other regulators remained untouched in terms of enforcement of the law covering financial institutions.

In June 1991, partly in response to the loss-compensation incident where major Japanese securities firms were found to be compensating securities losses to its best customers,[107] the SESC was established. Semi-independent from the MOF, the SESC was designed to conduct surveillance in regard to the maintenance of fairness in securities transactions. The commission was in charge of oversight of securities and financial futures transactions, and has the power to conduct investigation. If it finds violations, it can lodge an accusation with the public prosecutor's office for prosecution, or with the MOF for administrative action.[108] With limited staffing,[109] the SESC has conducted surveillance of over 80 securities companies, out of approximately 300 securities companies in Japan, and has investigated about 200 suspicious transactions every year for the past eight years. It lodged 30 accusations with the public prosecutor's office for criminal prosecution, and 154 recommendations for administrative action.[110] Although limited and insufficient, the establishment of the SESC introduced the concept of inspection in Japan.

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107. At the time, Japanese securities companies were providing investment management services using trust schemes for their major clients. The clients put their money into the trust, and allowed the securities firm to manage the account. The accounts were called *eigyo tokkin*. Securities firms preferred to compensate losses if they were able to gain commissions and future business from their best clients. In late 1990, stock price started to go down and it became apparent in 1991 that the Japanese economy had crashed. Clients' *eigyo tokkin* accounts became a problem for the securities firms: not only was it hard to meet their targets, the accounts suffered heavy losses by the end of 1989. The MOF, in response to the rumor that Daiwa Securities compensated its clients as much as USD $100 million, issued a 1989 memorandum urging the firms not to engage in the conduct. However, by then, the firms had no choice other than to ask the clients to close their accounts. The Securities Exchange Law at the time prohibited pre-arranged loss compensation, but did not mention after-the-fact compensation, so such compensation was made. It was reported that 21 securities firms in Japan compensated approximately JPY 170 billion in total. These transactions were available only for the "best" customers, strong corporations in Japan, and were criticized as being unfair, and lacking transparency. The MOF did not sanction any of the securities firms for this conduct, since there was an understanding in the market that non-prearranged compensation was not illegal. Instead, the MOF reacted by working on the new provision prohibiting both loss compensation and providing additional profit, and prohibited discretionary accounts for customers. The law was amended on October 1, 1990. For more on the scandals, *see* Milhaupt, *supra* note 31, at 461-465.

108. *See* Ruback, *supra* note 42, at 211- 212; Milhaupt, *supra* note 20, at 466.

109. *See* SEL (before amendment) Articles 55 and 56; *see also* Ruback, *supra* note 42, at 211-212.

110. *See* Annual Report, SESC, September 28, 2000, available at <http://www.fsa.go.jp/sesc/report/reportj/20000928-1a.html> (visited on March 24, 2001). English translation available at <http://www.fsa.go.jp/sesc/report/report-e.html> (visited on March 24, 2001). According to the JSDA, there are 291 member securities firms (including 53 foreign securities firms), and 238 other institutions (as of April 13, 2001). *See* <http://www.jsda.or.jp/html/gaiyou/gaiyou.html> (visited on April 15, 2001).

After the creation of the SESC, the MOF was still criticized for being too powerful.[111] The cabinet, with administrative reformation as one of its most important tasks,[112] decided to separate financial and fiscal planning and supervision of the financial industry prior to the reformation of other ministries[113] and let the new regulator, the Financial Supervisory Agency, undertake financial supervisory and regulation[114] in 1997. In June 1998, the new FSA was established, taking over supervisory and inspection authority for Japan's financial industries from the MOF.[115] Upon the establishment of the FSA, the commissioner of the FSA, a former prosecutor,[116] listed its basic five policies: (1) establishment of fair and transparent financial regulation, (2) conducting strict and effective inspection and monitoring, (3) strengthening tie-ups with foreign financial inspection supervisory agencies, (4) improvement of professionality and maintenance of high morale, and (5) improving equipment for inspection, monitoring and supervision.[117] FSA was still seriously understaffed when it was set up.[118]

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111. *See New Finance Watchdog Faces Credibility Hurdle From Get-Go*, THE JAPAN TIMES, June 20, 1998.

112. *See* Hashimoto Policy Speech, *supra* note 70.

113. For reform in other ministries, the Chuo shouchou tou kaikaku kihon hou [Basic Law on Central Government Reform], the Shouchou kaikaku kanren hou, [Amending Law on Central Government Reform], and the Shouchou kaikaku sekou kanren hou [Effectuation of the Amending Law on Central Government Reform] were established between June 1998 and December 1999, and the actual administrative reformation happened on January 6, 2001. *See* Chuo shouchou tou kaikaku – koremadeno haikei to nagare [Gist of the Central Government Reform], available at <http://www.kantei.go.jp/jp/cyuo-syocho/koremade.html> (visited on March 24, 2001).

114. *See* Jathon Sapsford, *Japan's Parliament Shifts Regulation of Financial Markets to a New Agency*, WALL ST. J., June 17, 1997, at 14.

115. *See* Anthony Rowley, *Tokyo Turns Screens on Financial Dirty Dealing*, BUS. TIMES (Singapore) March 13, 1997. The paper suggests an interesting correspondence regarding the timing between the cabinet approval of the establishment of the FSA (in March 1997) and first wide investigation of the long-lasting practice of paying-off *sokaiya* racketeers in 1997. In July 2000, the Financial Services Agency was created with the integration of the FSA and the Financial Planning Department of the MOF, which made the Financial Services Agency responsible for the planning of the financial system and supervision and inspection of financial institutions. *See also Press Release Statement by the Commissioner On the Establishment of the Financial Services Agency*, July 3, 2000, provisional translation of August 8, 2000 available at <http://www.fsa.go.jp/news/newse.html>, (visited on April 15, 2001); Yomiuri Online, *Kawaru okura eikyou ryoku teika ni?* [Is Influential Power Decreasing in the Changing MOF?], available at <http://www.yomiuri.co.jp/saihen/saihen305.htm> (visited on April 5, 2001).

116. *See Gov't to Appoint Prosecutor to Head Financial Watchdog*, THE DAILY YOMIURI, May 17, 1998, at 2; *see also Appointing Public Prosecutors to Create "Justice" No Use at All*, THE DAILY YOMIURI, June 17, 1998, at 6.

117. This was the gist of a statement by the commissioner at the press conference on the establishment of the Financial Supervisory Agency, June 22, 1998. Available at <http://www.fsa.go.jp/p_fsa/danwa/danwaj/dan-j-622.html> (visited on April 15, 2001).

118. Valerie Reitman, *New Japan Watchdog Herculean Task*, L.A. TIMES, July 19, 1998, at 1.

### 2. Changes in What

The lawmaking process still remains rigid. However, the MOF *shingikai* (advisory councils) that used to exist for each financial sector were rearranged into a *Kinyu shingikai*, a financial advisory council. The idea was to deal with the merging financial sectors,[119] and to reduce the friction between the regulator and the "public view" represented by the *shingikai*. In addition to the existing methods, a public comment system was adopted as one of the principle measures of financial reform.[120] Comments will be solicited on the web pages of the MOF and FSA, or other regulatory agencies of Japan when a new law or regulation is going to be passed.[121] This process, however, is not actually working yet, since there is an extensive discussion by the advisory council before the solicitation of comments. Since the effort to come to an agreement before public comment is substantial, it is suspect whether any public comments are adopted.

As for the interpretation of the law, the FSA has stated that its attitude toward regulation is "fair and transparent." This seems to be a statement of a major change in attitude. The FSA has proven that the regulator would not interpret the law for the benefit of the financial institutions, as we will later see in a series of inspections of foreign financial institutions. However, these changes were related to the collapse of a financial institution, and whether regulators are truly going to protect the fair and transparent market remains to be seen.

### 3. Changes in How

#### a. Communication

Together with the setup of the MOF itself, the close and closed communication system was widely criticized.[122] When the economy was doing well, the benefit of the financial institutions was in turn a benefit to

119. *See* Nakano and Yoda, *supra* note 29, at 38-39.

120. See Kakugi kettei, *Kisei no settei matara kaihai ni kakaru iken shoukai tetsuzuki* [Cabinet Council Decision, Regarding the Established Procedure for Public Comment], available at <http://www.somucho.go.jp/gyoukan/kanri/a_07_01.htm> (visited May 19, 2001.

121. For example, public comment was solicited by the FSA at <http://www.fsa.go.jp/public/public.html> (visited on April 15, 2001) and by the MOF at <http://www.mof.go.jp/comment/itiran.htm> (visited on April 15, 2001).

122. *See, e.g.*, Gillian Tett, *Japanese Aghast as Murky Secrets Emerge*, FIN. TIMES, January 31, 1998, at 2; Sheryl WuDunn, *Like the Geisha, the Good-Time Bar Is Endangered*, THE N.Y. TIMES, May 19, 1998, at 4; Michio Sato, *Time to Get Rid of Root Rot in Top Echelons of Finance Ministry*, THE DAILY YOMIURI, March 11, 1998, at 7; *Mafia of Mof-tan Corrupted the Bureaucrats*, Asahi Shimbun, February 3, 1998.

other sectors and the public. However, when financial institutions started to weaken, the public felt that the government treated financial institutions unfairly favorably, and under public scrutiny, the web of communication and longstanding system of regulation started to collapse.

In 1993, the Administrative Procedure Law[123] was promulgated "to maintain fairness and improve transparency of administrative procedure, and thus contribute to the protection of rights and benefit of the people."[124] The law was unique in that it has one independent chapter on administrative guidance.[125] In that chapter, it is provided that acting upon administrative guidance should be at the option of the recipient, and that action taken contrary to guidance should not be sanctioned by disadvantageous treatment.[126] It also provided that when oral administrative guidance is given, the authority should issue a written document upon request, specifying the purpose, content, and the person in charge.[127] However, this law had no major effect on the process of communication between the financial institution and the regulator. Financial institutions were still protected and controlled by close communication with the regulator, and it did not wish to take advantage of the new law.

However, public attitudes for this communication method were becoming more and more against prevailing practice.[128] In June 1998, a symbolic announcement was made from the MOF calling for the abolishment of *tsutatsu* issued by the MOF in the financial services industry. *Tsutatsu* is a form of administrative guidance aimed to communicate views of the regulator on various topics, including operation of financial institutions, and guidelines for treatment and applications to the ministry.[129] In order to promote deregulation, and to create a "transparent and fair financial regulation pursuant to clear rules," the MOF abolished major parts of *tsutatsu* and reformed others. It abolished over 500 *tsutatsu* regarding guidance of specific financial businesses, and put others into the internal

123. *Gyousei tetsuduki hou* [*Administrative Procedure Law*], APL Law No. 88 of 1993; for background and more information on the contents, *see* Uga, *supra* note 44.

124. *See* APL, *supra* note 123, at Article 1.

125. *See id.* at Chapter 4, Article 32 to 36.

126. *See id.* at Article 4, paragraph 1 and 2; Article 34.

127. *See id.* at Article 35, paragraph 2.

128. *See, e.g.*, Gillian Tett, *Japanese Aghast as Murky Secrets Emerge*, FIN. TIMES, January 31, 1998,at 2; Sheryl WuDunn, *Like the Geisha, the Good-Time Bar Is Endangered*, THE N.Y. TIMES, May 19, 1998, at 4; Michio Sato, *Time to Get Rid of Root Rot in Top Echelons of Finance Ministry*, THE DAILY YOMIURI, March 11, 1998, at 7; *Mafia of MOF-tan Corrupted the Bureaucrats*, THE ASAHI SHIMBUN, February 3, 1998.

129. Banks had to get approval to open a new branch. Even after getting approval, the tsutatsu instructed the setup of the branch in detail, even including the position of the counter and the entrance (*tenpo secchi basho kijyun*). *See* Nakano and Yoda, *supra* note 29, at 138-139.

manual of the MOF, "*jimu* guideline" (operating guidelines[130]) and other forms.[131] Afterwards, and with the declared establishment of fair and transparent financial regulation by the FSA,[132] the regulator stopped giving administrative guidance.

The method of communication initiated by the financial institutions, MOF-tan, was also abolished around the same time. First, there was criticism that officials of the MOF sometimes have too close a relationship with the financial institutions they supervise. In 1995, after two credit unions in Tokyo failed, it was revealed that the president of the failed credit union had a close relationship with Ministry officials.[133] The president, at the time, was prosecuted by the management of the failed credit union for breach of trust, for allegedly making enormous non-performing loans to their respective business groups.[134] Although the relationship did not trigger criminal prosecution for the MOF officials, the relationship was widely criticized,[135] and resulted in the Ministry punishing 112 of its officials for accepting excessive entertainment from financial institutions.[136] Then, there was another scandal involving MOF-tan. In January 1998, it was discovered that MOF-tan of major banks in Japan were not only maintaining a close relationship to exchange information; they were also providing unreasonably expensive entertainment to MOF officials in order to obtain approval of a new product in advance of a rival financial institution, and to obtain information on details of a coming "surprise" inspection. This time, the incident resulted in prosecution of ministry officials,[137] and the ministry decided to punish about 100 officials for accepting excessive favors.[138] Following the incident, most Japanese banks announced the abolishment of

130. The "*jimu* guideline" is available at the FSA homepage, <http://www.fsa.go.jp/guide/guide.html> (visited on April 6, 2001).

131. *See* MOF Press Release, *On Abolishment of Financial Related Tsutatsu*, June 8, 1998, available at <http://www.mof.go.jp/jouhou/kabu/ka008.htm> (visited on March 4, 2001).

132. *See supra* note 117.

133. *See Takahashi Developed Close Ties with Bank Bureau Officials*, MAINICHI DAILY NEWS, March 16, 1995, at 12.

134. *See 2 Credit Banks Claim Breach of Trust*, THE DAILY YOMIURI, February 28, 1995, at 1; *2 Credit Unions File Criminal Charges Against Ex-Bosses*, MAINICHI DAILY NEWS, February 28, 1995, at 1.

135. *See, e.g.*, Kevin Rafferty, *"Descent From Heaven" and a Fall From Grace*, THE OBSERVER, October 8, 1995, at 4; Willian Dawkins, 'Honesty school' for bureaucrats, FIN. TIMES, Sept. 29, 1995, at 5; Jin Nakamura, *Economic Forum: Scandal Could Open the Door to Reform of a Bureaucratic Monster*, THE DAILY YOMIURI, Sept. 27, 1995, at 7.

136. *See* Editorial: *Sever Ministry-Finance Firm Ties*, THE DAILY YOMIURI, April 28, 1998, at 6.

137. *See* Jonathan Watts, *Japanese Inspectors Held: Ministry Officials Accused of Accepting Lavish Hospitality From Banks*, THE GUARDIAN, January 27, 1998, at 19.

138. *See MOF Plans to Punish 100 Officials*, MAINICHI DAILY NEWS, April 22, 1998, at 12.

their MOF-tan.[139] In April 2000, the *kokka koumuin rinri kitei* [Governmental Ordinance on Ethical Standards for Ministry Officials][140] (executed by triggering legislation[141]) was promulgated.[142] The law prohibits government officials from using their position to benefit themselves,[143] requiring officials to refrain from any activity that will raise suspicion such as receiving gifts,[144] and requiring disclosure for the receipt of gifts in order to maintain transparency.[145]

The regulator and the financial industry's surrender of their traditional communication methods before an alternative method was adopted resulted in almost no communication between the financial institution and the regulator. The regulator, however, is making some effort to establish a new method of communication. A Japanese version of no-action letters is now under discussion. Regulators have also adopted a legal and regulatory interpretation reference system (*hourei kaishaku shoukai seido*).[146] However, this system has not been working due to a lack of resources. The plan for fiscal year 2001 included a five-fold increase of the number of regulators to deal with the reference system. It is still premature to evaluate the success of the system, but it seems that the regulator is at least working on the issue.

b. Lower cost of breach, higher profit from breach

Under this new regulatory situation, inspection was ready to be introduced. Financial institutions started to have incentives to violate laws and regulations, if the cost of the violation was less than the resulting profit. There was almost no such incentive in the old regime. However, where there is competition, and the stock market reacts to the profit and loss of the financial institutions, they started to care about profit and loss just like other companies. Since the convoy system collapsed, the cost of breach relatively

139. *See Major Banks Plan Ethics Codes Following Entertainment Scandal*, THE DAILY YOMIURI, January 31, 1998, at 12.

140. Law No. 101 of March 28, 2000.

141. Kokka koumuin rinri hou [Law on Ethics for Ministry Officials], Law No.129 of August 13, 1999.

142. An explanation of the law is available in the 1999 National Personnel Authority White Paper, available at <http://www.jinji.admix.go.jp/ hakusho/h11/haf.htm> (visited on April 7, 2001); *see also Koumuin rinri hou – genin chiryou no hou mo wasureruna* [Law on Ethics for Ministry Officials – Don't Forget to Treat the Cause], MAINICHI SHINBUN, April 20, 2000, available at <http://www.mainichi.co.jp/eye/shasetsu/ 200004/02-1.html> (visited on April 8, 2001).

143. *See supra* note 141 at Art. 3 para. 2.

144. *See supra* note 141 at Art. 3 para. 3.

145. *See supra* note 141 at Art. 6.

146. *See, e.g., Jimu Guideline Regarding Supervision of Securities Companies*, available at <http://www.fsa.go.jp/guide/guide.html> (visited on April 15, 2001).

declined. It was obvious that financial institutions would not be protected no matter how faithful they were to the regulator. Also, it was expected that financial institutions would be sanctioned in accordance with the seriousness of the violation, not in accordance with their relationship with the regulator or the strength of the company. On the other hand, there was a tendency for the profit of violations to increase. Deregulation of financial services proceeded gradually, and there was more freedom in structuring products. Requirements for securities companies changed from a licensing requirement to a mere registration requirement. Since the regulator took the position that it would allow registration if the applicant met with the formalistic requirements, it would be relatively easy for newcomers to participate in the market.

There was thus more incentive for inspection. Under such an environment, the regulator was not able to wait until a violation, especially when it turned out that they were actually not able to know what was going on with the financial institutions. Also, since the incentive for violation was going up, there was a need to introduce inspection. Financial institutions were then less willing to communicate, since that meant they would have to give up the chance to gain profit.

#### c. The FSA Declaration for Inspection-Driven Regulation[147]

As financial institutions started to fail, even the regulator was not able to see the whole picture of the amount of the bad debt, due to insufficient disclosure. As the government injected funds to financial institutions, it was demanded that the government have the full picture as soon as possible, which became a strong reason for the regulator to emphasize inspection. Upon the establishment of the FSA in June 1998, the commissioner of the FSA stressed that it would establish strict and effective inspection and solid monitoring. He also mentioned that it was a very basic requirement to convert the administration into an "after-the-fact checking type." To achieve this goal, he said that the regulator would keep reviewing and improving the inspection method, and would educate and train its inspectors and strengthen the inspection function through communication with civilian experts and foreign financial inspectors. It also was pointed out that the regulator would improve not only on-site examinations, but also off-

147. *See* Gillian Tett, *Tougher Inspections at the Big Banks are Being Followed by Closer Examination of the Regional Lenders and Life Assurance Companies*, FIN. TIMES, June 21, 1999, at 2.

site monitoring through following up the issues raised by the inspection, and a review of the financial documents of financial institutions.[148] The government was serious about the inspection, especially in order to uncover the bad debts that most Japanese financial institutions carried. It is also worth noting that the chief of the Financial Reconstruction Committee, the government agency superior to the FSA in charge of financial reform and financial regulation, was forced to resign in February 2000, because of his comment to go easy on inspection of the regional banks.[149]

The regulator, although ambitious, still lacked sufficient resources and expertise. The regulator only had 151 inspectors with the agency, far from sufficient,[150] and there were not enough capable inspectors that could deal with financial products in the current market. In response to such concerns, the agency more than doubled the number of inspectors, to 319 in 2000.[151] It also came up with several plans to improve the level of the inspectors. It first offered extensive training to the inspectors, covering methods of inspection and knowledge of derivatives.[152] It also hired temporary inspectors with skills in certain areas, to import expertise and knowledge into the agency, and also to recruit that person if possible. To that end, the FSA advertised for recruitment of inspectors for specific areas. For example, the FSA asked for people to work at inspection in compliance situations, internal auditing situations, market related risks, e-commerce/IT, and investigating liability reserves of insurance companies, advertising ten positions on their homepage in February 2001.[153]

### C. *The New Japanese Compliance System*

#### 1. Compliance in Japanese Firms

There was a growing public demand for compliance in the public, partially due to one particular huge financial scandal. In 1997, several major

148. *See supra* note 117.

149. *See Foes Call For Japan's Top Financial Regulator To Resign*, WALL ST. J., February 25, 2000, at 17; *see also* Gillian Tett, *Japanese Minister Forced to Quit After Bank Gaffe: Departure of Politician Regarded as Unenthusiastic About Financial Reform Delights Foreign Bankers*, FIN. TIMES, February 26, 2000, at 6.

150. *See* Valerie Reitman, *New Japan Watchdog Herculean Task*, L.A. TIMES, July 19, 1998, at 1; Mari Kiseki, *New Finance Watchdog Faces Credibility Hurdle From Get-Go*, THE JAPAN TIMES, June 20, 1998; *Financial Watchdog*, MAINICHI DAILY NEWS, June 25, 1998.

151. *See* FSA kikou, teiin oyobi yosan (gaisan kettei) [FSA Organizational Structure Headcount and Budget (estimate)] for fiscal year 2001. Available at <http://www.fsa.go.jp/kouhou/kouhou_01/006_1301.pdf> (visited on April 4, 2001).

152. *See* Nakano and Yoda, *supra* note 29, at 194-195.

153. The positions are already filled, but the statement is still available at <http://www.fsa.go.jp/news/newsj/kinyu/f-20010208-2.html> (visited on April 4, 2001).

financial institutions and most of their executive managers were found to have provided benefits to *sokaiya* racketeers. Since the scandal involved most of the major securities firms, as well as other financial institutions and large corporations, the public demanded the establishment of a solid compliance environment for financial institutions.[154]

The current regulations became more favorable to the establishment of a specific compliance program. Since the regulator theoretically liberalized legal interpretation, and stopped mandating its own interpretation, financial institutions were forced to interpret the law at their own risk, with the input of the council or other experts. Also, since the regulator was shifting to a stricter inspection system, and stopped dealing with potential problems in advance, the financial institutions had to have an environment that would detect problems before inspection. The FSA stressed that it would view compliance as an important factor for financial institutions under the new regulations. It issued a financial inspection manual for bank inspections in April 1999,[155] that detailed the items the inspectors would examine in order to evaluate the compliance systems of financial institutions: (1) the establishment of compliance systems, (2) the formulation of compliance standards (behavioral rules), (3) the establishment of checks to determine if compliance systems were functioning adequately, and (4) sanctions for compliance violations, and

154. The word compliance started to be widely used in Japan after the top management of the largest companies of Japan were arrested for paying off *sokaiya* in 1997. *Sokaiya* are racketeers who blackmail a company by threatening to accuse the management of misdeeds, or reveal information the management does not want to disclose, at the company's shareholders' meeting. The CEO of Nomura Securities was sentenced to one year in jail, with three years' probation, together with three other senior managers of the company. Seven other senior managers at Dai-Ichi Kangyou Bank, six senior managers at Daiwa Securities, and six senior management at Yamaichi Securities were found guilty, and a former CEO is still before the court. Other than financial institutions, companies such as Takashimaya, Ajinomoto, Mitsubishi Automobile, Toshiba, Mitsubishi Electric, Matsuzakaya, Mitsubishi Real Estate, and Hitachi were found to be involved. A list of loss compensation incidents is available in *Kabunushi soukai hakusho* [*White Paper on Shareholders' General Meetings*], 1510 SHOUJI HOUMU at 16 et. seq. An abbreviated version is available at <http://www.shojihomu.or.jp /whats2/wn99-4-21.html> (visited on March 5, 2001). For more on sokaiya, *see* Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 U. CHI. L. REV. 41 (2000); Mark D. West, *Information, Institutions, And Extortion In Japan And the United States: Making Sense Of Sokaiya Racketeers*, 93 NW. U. L. REV. 767 (1999); Lt. Bruce A. Gragert, *Yakuza: The Warlords of Japanese Organized Crime*, 4 ANN. SURV. INT'L & COMP. L. 147 (1997); Joanna Pitman, *Corporate Extortion Brings Shame to Tokyo Firms*, THE TIMES, Sept. 29, 1997.

155. *See Financial Inspection Manuals*, April 8, 1999, provisional translation available at <http://www.fsa.go.jp/p_fsa/news/newse/ne_023.html> (visited on November 10, 2000). An Inspection Manual for Insurance Companies was also issued; it is available at <http://www.fsa.go.jp/manual/manual.html> (visited on April 16, 2001). The FSA manual is only available for banks and insurance companies; a manual for securities companies is currently under discussion.

enforcement of compliance rules.[156] Through the Daiwa bank incident and other such incidents, it became evident that financial institutions had to fix their internal control problems, since there were no methods to detect violation of a rule if an employee was trying to hide it. Installing compliance programs was even more urgent because of the recession, since Japanese firms had to lay off substantial numbers of employees, and the lifetime employment system was starting to collapse. In such a situation, there it was necessary to maintain efficient and sufficient communication within firms.

In 1997, in this business climate, the Japanese Bankers Association (*Zenginkyo*) and the JSDA announced several papers relating to compliance and ethical standards for financial institutions.[157] (*Zenginkyo* issued papers regarding compliance and ethical standard for banks, and the JSDA issued a paper regarding restoring confidence in securities companies.) Financial magazines widely circulated among Japanese financial employees also started to publish articles on the issue of "compliance."[158]

Japanese financial institutions responded to the messages. In 1999, the Mizuho Financial Group—a financial group formed by three major Japanese financial institutions, Industrial Bank of Japan ("IBJ"), Dai-ichi Kangyo Bank ("DKB") and Fuji Bank—formed, under one holding company, Mizuho Financial Holdings, and that new company listed compliance as one of its key management policies. The press statement declared, "Compliance is viewed as one of the fundamental principles of sound business management. [Mizuho] will aim for strict compliance with applicable laws and regulations, and an independent audit and inspection system, with extensive check and verification functions, will be established."[159] When Tokyo-Mitsubishi Bank, Mitsubishi Trust Bank and Nippon Trust Bank announced establishment of the Mitsubishi Tokyo Financial Group in September 2000, its "Management Infrastructure" stated

156. *See id.* at Part 2, I. Compliance System Check List.

157. *See* Japanese Bankers Association, *Ginkouno shakai teki sekinin to compliance ni tsuite* [*Banks' Social Responsibilities and Compliance*] (July 1997), in 1491 KINYU HOUMU JIJYO at 60-61. *See also* Rinri Kenshou [Ethics Charter], 1499 KINYU HOUMU JIJYO at 10; Japan Securities Dealers Association, *Shinrai kaifuku nimukete no gutai saku* [*Concrete Steps toward Restoring Confidence*], August 1997.

158. *See* Kinyu Zaisei Jijyou, *Kinyuu houmu wo yomu 10 no point (1) Kinyu Kikan ni okeru compliance* [*Compliance Seminar for Branch Managers, (1) Why Compliance Now?*], 1511 KINYU HOUMU JIJYO (1998) at 6-7; *see also Kinyuu kikan ni okeru compliance*, 1514 KINYU HOUMU JIJYO (1998) at 6-51. By this time, the word "compliance" was integrated into Japanese, and "spelled out" with *katakana*, a Japanese phonetic alphabet used to depict foreign-originating words.

159. *See* Mizuho Group Press Release (English version VIII. 4.), *Foundation of the Mizuho Financial Group Through the Consolidation of DKB, Fuji Bank and IBJ: Announcing the Execution of the Formal Agreement for Comprehensive Consolidation*, December 22, 1999, available at <http://www.mizuho-fg.co.jp/sousetsu/gaiyo/gaiyo_05.html> (visited on November 10, 2000).

"The group sees the achievement of total compliance as one of management's primary objectives, and will take all necessary steps to clarify relevant legislation and company rules, to establish the necessary systems in each group company, and to ensure that all employees are fully familiar with what they can and cannot do."[160]

"Compliance" in this context was often defined as institutions being in compliance with laws and regulations, as well as moral, ethical, and social norms.[161] Although we will need to wait and see how such systems will work and interrelate, Japanese financial firms have finally started to adopt compliance programs.

### 2. Compliance in Foreign Firms in Japan

The presence of foreign firms increased dramatically during the late 1990s.[162] While Japanese financial institutions were struggling with bad debts, some tried to find their way out by seeking help from foreign financial institutions. Before it failed, Nippon Credit Bank tied up with Banker's Trust, and Merrill Lynch purchased Yamaichi Securities after its collapse, forming Merrill Lynch Japan Securities in 1998.[163] Japan's Long Term Credit Bank ("LTCB") was purchased by Ripplewood, a U.S. private equity group, in 1999. Salomon Smith Barney finalized a joint venture with Nikko Securities on March 1, 1999.[164] As the deregulation continued, foreign financial institutions started to play an important role in the Japanese

160. The Bank of Tokyo-Mitsubishi, Ltd., The Mitsubishi Trust and Banking Corporation, Nippon Trust Bank Limited, *Establishment of Holding Company: Mitsubishi Tokyo Financial Group*, September 13, 2000, available at <http://www.MTFG.co.jp/english/ invest/index2.html> (visited on April 16, 2001).

161. The Japan Banker's Association (*Zenginkyo*), in its commentary for the Moral Charter (*rinri kensho*), defines compliance "not only strictly complying with laws and rules, but further, to accomplish social norms." Japanese Bankers Association, *Rinri kenshou*, September 1997, available at <http://www.zenginkyo.or.jp/rinri/rinri.htm> (visited on April 15, 2001). The FSA defines compliance as compliance with laws and regulations and internal rules.

162. *See* Sheryl WuDunn, *Japan Braces For Arrival Of "Big Bang" Financial Services Industry Is Opening to Foreigners*, THE N.Y. TIMES, June 4, 1998, at 1; Gillian Tett, *Unthinkable a Decade Ago, Foreign Investors are Starting to Purchase their Former Japanese Competitors*, FIN. TIMES, October 19, 1999, at 2.

163. *See* Oliver August, *Merrill Brokerage in Japan*, THE N.Y. TIMES, February 13, 1998; Sheryl WuDunn, *Japan Braces For Arrival of "Big Bang": Financial Services Industry Is Opening to Foreigners*, THE N.Y. TIMES, June 4, 1998, at 1; Gillian Tett, *Unthinkable a Decade Ago, Foreign Investors are Starting to Purchase their Former Japanese Competitors*, FIN. TIMES, October 19, 1999, at 2.

164. In early 1999, Citigroup established Nikko Salomon Smith Barney as a wholesale securities joint venture with Nikko Securities Co., Ltd., through Salomon Smith Barney, its investment banking and brokerage arm. *See Nikko Salomon Smith Barney Overview*, available at <http://www.nssb.co.jp/ overview/overview.html> (visited on April 4, 2001).

financial market. Additionally, domestic financial institutions tried to do business with foreign institutions in order to import advances technologies. In 1999, J.P. Morgan and DKB set up a joint venture, DKB Morgan, to structure a securities investment trust product.[165] Once the big bang began, there was a widely shared concern that the country would suffer from so-called "Wimbledon symptoms," where foreign financial institutions wipe out all domestic financial institutions. Although their share levels are not high, five foreign brokers (including Nikko Salomon) place in the top ten underwriters in the domestic bond market.[166] Citibank became so popular for retail Japanese customers that it was frequently listed as one of the best banks in Japan.[167]

The creation of investor protection funds demonstrates how powerful foreign securities firms became in Japan. In late 1998, the law was amended to make it mandatory for securities firms to be a member of an investors' protection fund that would protect customer assets held by the securities firm. The law also required securities firms to segregate customer assets from their own assets. The provisions on the investors' protection fund were to be enforced from December 1998, while the segregation requirement was not to be enforced until April 1999. Before the enactment of the law, the MOF was planning to make the JSDA create a fund, the Japan Investors' Protection Fund, for that purpose. However, there was a concern that if a securities firm that was a member of the fund collapsed before April, since segregation of assets was not required until then, there would be a high possibility that other member firms would be made to pay.[168] Since foreign financial institutions were more stable financially, it was expected that foreign firms would have to pay for the failure of domestic firms. Foreign firms were concerned that they would not be able

165. *See J.P. Morgan and The Dai-Ichi Kangyo Bank, Ltd., J.P. Morgan Investment Management Inc. and The Dai-Ichi Kangyo Bank, Ltd. to Enter into Exclusive Joint Venture Agreement to Offer Investment Trusts*, October 1, 1998, available at <http://www.dkb.co.jp/english/press/199810/981001.html> (visited on April 15, 2001). *See also* Gillian Tett, *JP Morgan in Japanese Mutual Fund Deal*, FIN. TIMES, October 2, 1998, at 28. The new company was later agreed to be wholly owned by DKB. *See J.P. Morgan and The Dai-Ichi Kangyo Bank, Limited, J.P. Morgan Investment Management Inc. and The Dai-Ichi Kangyo Bank, Ltd. Group to Establish New Relationship in Regards to Securities Investment Trust Business*, Sept. 22, 2000, available at <http://www.dkb.co.jp/release/200009-3/20000922.html> or <http://www.jpmorgan.co.jp/about/release/dkbjpm.shtml> (visited on April 15, 2001).

166. *See* Lindorff, supra note 63.

167. In December 2000, it even ranked number one for financial institutions that consumers would be willing to transact with in the future. *See* NIKKEI MONEY, April 1, 2000, available at <http://www.citibank.co.jp/pr/cust/index.html> (visited on April 15, 2001).

168. *See* Anthony Rowley, *Backlash Feared as Foreign Fund Managers Invade Tokyo*, BUS. TIMES (Singapore), November 9, 1998, at 1,4; Gillian Tett, *Tokyo Fund Faces Threat of Boycott*, FIN. TIMES, October 21, 1998, at 8.

to make the MOF listen to their concerns, and then started the work to set up their own fund, the Japan Securities Investors' Protection Fund, with strict conditions for membership.[169] The MOF finally approved the fund, acknowledging that it was possible to have two funds under the SEL.[170] This incident showed how powerful foreign financial institutions were becoming in Japan.

The regulatory environment for foreign financial institutions has also changed. Since there was limited unofficial communication between foreigners and the regulator, it could be said that from one perspective, the regulators' cessation of unofficial communication with financial institutions had limited effect as to foreign institutions. However, the situation changed drastically when the regulator started to inspect the institutions more seriously, and the FSA announced it would conduct inspection of foreign financial institutions as well. There was a fear among foreign financial institutions of an anti-foreign backlash, and that the regulator was just trying to give foreigners a hard time. In response to such fears, the deputy head of the FSA was reported to have said, "We will treat foreign and Japanese firms in exactly the same way."[171] Nonetheless, there will still be a major change for foreign firms. Foreign firms had not been "regulated" in the Japanese market, comparatively with Japanese firms, where under the new system, they would be regulated more stringently. In response to this movement, compliance for foreign firms in Japan also seems to be changing, as exemplified by the current high demand for skilled compliance officers.[172]

## V. PERSPECTIVE FOR THE FUTURE: INSIGHTS FROM THE CSFB INCIDENT

The FSA made a statement in May 1999 that it would inspect foreign financial firms as well as domestic ones. Prior to this statement, in

169. *See* Tett, *supra* note 168.

170. *See Shouken gyoukai: "toushisha hogo kikin" gaishikei no bunretsu hossoku ga kakutei [Securities Industry: Separate "Investor's Protection Fund" for Foreign Firms Confirmed]*, MAINICHI SHINBUN, November 28, 1998, available at <http://www.mainichi.co.jp/news/selection/archive/199811/28/1128m161-200.html> (visited on April 8, 2001).

171. Gillian Tett, *Tougher Inspections at the Big Banks are Being Followed by Closer Examination of the Regional Lenders and Life Assurance Companies*, FIN. TIMES, June 21, 1999, at 2.

172. One paper quotes a banker saying, "It's crazy – top compliance staff are being offered well over $1 million a year." *A Little Local Difficulty in Japan: As Tokyo's Financial Regulators Try to Impose Higher Standards, They Are Causing Confusion and Resentment*, FIN. TIMES, June 23, 2000, at 15.

January 1999, the regulator started the CSFB inspection during a time in Japan when major financial institutions like Yamaichi and Hokutaku, that were believed to be too important to fail, collapsed. There was suspicion that several others, including LTCB and NCB, might follow, and the belief that their real financial status was still undisclosed was causing more anxiety. In the inspection of CSFB, the regulator investigated the head office of CSFP (the derivatives arm of CFSB) in the United Kingdom, with the cooperation of the U.K.'s FSA.[173] The Japanese FSA finally announced administrative action in July 1999. Afterwards, a series of administrative actions was taken against foreign financial firms from 1999 to 2000.

The CSFB incident is of interest in two ways. First, the regulator proved that it achieved two of its major goals: inspection, and shifting its emphasis from protection of financial institutions to protection of markets. Second, however, the incident demonstrated the result of what can happen in a situation where there are no clear rules and no communication. This section will explain what happened during the incident, and will then clarify the benefits and problems of administrative action.

### *A. The Factual Background*

#### 1. Explanation of the Violations

The FSA announced that it found CSFP and Credit Suisse Trust and Banking Co. ("Credit Suisse Trust," the trust bank subsidiary of CSFB group) to have committed three wrongs: (1) providing "window dressing transactions," which was "extremely inappropriate from the standpoint of adequate disclosure of its clients' financial conditions," (2) violating firewall regulations, and (3) conducting "systematic evasions and obstructions of inspections" such as shredding and hiding documents. Other subsidiaries were found to be in violation of other laws or operating without sufficient control mechanisms. Based upon these inspection results, the FSA revoked the banking license of CSFP, suspended indefinitely the business of Credit Suisse Trust,[174] and suspended business for a shorter period for other subsidiaries.[175]

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173. *See Kinyu kensa: Kinyu group CSFB sanka ginkou wo nichi-ei kyoudou kensa,* [*Financial Inspection: Japan/U.K. Joint Inspection of CSFB Subsidiary Bank*], MAINICHI SHINBUN, March 5, 1999, available at <http://www.mainichi.co.jp/news/selection/archive/199903/05/0305m165-200.html> (visited on November 9, 2000).

174. The suspension was lifted in December 2000. Based upon the bank's request, the regulator decided to lift the suspension, based on the proposition that the bank had improved its legal compliance and management system, and Credit Suisse Group had been enforcing its overall compliance system as well. *See* Financial Services Agency Press Release, *Removal of the Order of*

a. Window dressing transactions

As described above, major securities firms and banks in Japan collapsed in and around 1997. It was reported that the FSA was suspicious that the losses in those failing financial institutions were not disclosed to the public partly because those institutions were purchasing window dressing products.[176] Window dressing products are products, or a scheme of transactions, using trusts, re-packaging, derivatives, and others instruments, to allow a company to dress its financial statements so that depreciated assets would not be disclosed on the statements.[177] It was said that foreign financial institutions became a provider of these complex products, since they had the requisite skill for such products, and because Japanese financial institutions were hesitant to disclose losses to competing Japanese banks.[178] This area appeared to be extremely profitable, and some firms started to market those products heavily, finally leading the FSA to pose administrative sanctions.[179]

b. Firewall violations

Firewall regulations in Japan are a version of the United States Glass-Steagall Act separating banking and securities entities.[180] The MOF regulated financial institutions strictly on an entity by entity basis, not on a group basis. This method, however, was not enforced strictly against foreign financial firms. Most of the foreign firms were operating as one financial group, providing a wide range of products, conducting business management and risk management as a group, since it was easier to do so. In June 1998, the FSA announced relaxation of firewall regulations,[181] and

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*Suspension Regarding Credit Suisse Trust and Banking Co. Ltd.*, December 28, 2000, provisional translation available at <http://www.fsa.go.jp/news/newse.html> (visited on April 15, 2001).

175. *See id.*

176. *See* Gillian Tett, *Former LTCB Chiefs Face Charges*, FIN. TIMES, June 5, 1999, at 4.

177. *See* Gillian Tett, *Help With "Window Dressing" May Cost Tokyo's Foreign Banks Dear*, FIN. TIMES, April 6, 1999, at 6.

178. *Id.*

179. *See* Gillian Tett, *Credit Suisse: The Hidden Truth Behind the Mask*, FIN. TIMES, June 18, 1999, at 8.

180. Banking Law Art. 10 provides the basic principle of the prohibition of securities business by banks, and provides certain situations in which the banks can engage in certain securities business. SEL Art. 65 prohibits participation in securities business by financial institutions. SEL Art. 45 poses restrictions on certain activities between securities firms and their group companies.

181. *See* FSA/MOF Press Release, *On Amendment of the Ordinance Regarding* koui kisei tou *of Securities Companies*, June 5, 1998, available at <http://www.fsa.go.jp/p_fsa/news/news-j.html> (visited on April 7, 2001); FSA Press Release, *On the Partial Amendment of Operational Guideline*

at the same time, warned foreign financial institutions that the regulator would not be as generous as it had been in the past on the subject. However, it was not possible to change management styles in a day, and therefore, it is imaginable that the FSA was expecting to find firewall violations in the group.

#### c. Obstruction of inspection

The inspectors must have been surprised when they found there was systematic obstruction of inspection by the CSFP management, including their compliance officer. When the regulators started the inspection, several managers and other members of staff attempted to interfere with the inspection by concealing and destroying documents.[182] The company explained that the "primary motivation for the misconduct was to conceal activities that may have violated the strict regulatory separation of the banking and securities business in Japan," apologized to the regulator for the misconduct of certain members of its staff, and terminated the employment of the individuals concerned.[183] Although the company argued that it had nothing to do with the obstruction, CSFP was ordered by the Tokyo District Court to pay a JPY 40 million (US $334,000) fine, the court reasoning that "the criminal responsibility was serious" since it was a "planned" act.[184] In a separate ruling, the court found the former head of CSFP Tokyo guilty of criminal violations.[185]

### 2. Administrative Action against Other Brokers

After the CSFB statement was released, several other financial groups were subjected to administrative sanction due to the provision of window-dressing transactions. First came word that Lehman Brothers was reported to have suspended its structured products business for one week in October 1999.[186] Another landmark decision was the case of Deutsche

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*(Volume 2)*, June 30, 1998, available at <http://www.fsa.go.jp/p_fsa/news/news-j.html> (visited on April 7, 2001).

182. *See* Tett, *supra* note 179, at 8; Credit Suisse Group Press Release, *Credit Suisse Group Announces Results of an Independent Report Concerning Certain Events in Japan*, May 21, 1999.

183. *See* Credit Suisse Group Press Release, *Credit Suisse Group is notified of sanctions in Japan*, July 29, 1999.

184. Emiko Terazono, *Tokyo Court Fines CSFP Y40m; Financial Services Derivatives Arm Guilty of Blocking Government Inspectors*, FIN. TIMES, March 9, 2001, at 33.

185. *See* Paul Abrahams, *Ex-Credit Suisse Official Arrested in Japan*, FIN. TIMES, November 18, 1999, at 16; Terazono, *supra* note 184; *Failed Bank "Faked Accounts"; CSFP Head of Tokyo Office Four Months in Jail, Suspended for Two Years*, ASAHI SHINBUN, Sept, 25, 1999.

186. *See* Gillian Tett, *Lehman Brothers Breaches Japanese Investment Rules Banking U.S.*

Securities Ltd., since the legal explanation given in the administrative action became the model for actions in other firms.

FSA launched a surprise inspection of Deutsche Securities in Tokyo in August 1999. Just like the CSFB inspection, approximately 40 inspectors arrived on site, and the SESC eventually uncovered window-dressing transactions. In May 2000, the FSA took administrative action against Deutsche Securities, consisting of (1) a ban on applying for approval to commence trading in OTC derivatives for six months; (2) suspension of its bond trading and brokerage business for two weeks; (3) suspension of its business regarding swaps, the purchase and sale of loans, execution of loan participation agreements, consulting in regard to company management, and consulting regarding securities for five days; (4) suspension of Japanese Government Bond ("JGB") futures brokerage for two days; and (5) submission of a plan to establish internal control and compliance procedures.[187] The FSA explained that one branch proposed to a customer that the customer should hold depreciated securities, a scheme that would enable the customer to defer disclosure of a loss, which would be a violation of the ban on soliciting securities business by promising to provide special benefits.[188] It is unclear as to which sanction was imposed for the window-dressing transactions uncovered by the SESC, but it is fair to say that Deutsche Securities received a substantially milder sanction than did CSFP. The relatively relaxed sanction was given since Deutsche "(1) during and after the inspection adopted a policy of complete transparency with the regulators, and (2) the company also indicated both to the regulator and the market that it supports the Government policy of making the financial markets more transparent—including by eliminating so-called 'inappropriate transactions' from the market place."[189]

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*Group Suspends its Structured Products Operations after Regulator Uncovers Violations*, FIN. TIMES, October 5, 1999, at 38.

187. *See* FSA Press Release, *On the Administrative Action to Deutche Securities, Tokyo Branch*, May 24, 2000, available at <http://www.fsa.go.jp/p_fsa/news/news-j.html> (visited on April 15, 2001).

188. *See* Shoken gaisha no kenzensei no junsoku to ni kansuru shorei [Ministry Ordinance Regarding Standards, etc. for Soundness of Securities Firms], MOF Ordinance No. 60 of 1965 Art. 2, Para. 2 (pre-amendment). It is interesting that the FSA used the article, since it is separate from the prohibition of loss compensation. It was originally designed to prohibit kickbacks and other financial benefits used to avoid the fixed commission requirement. The FSA used the article to cover non-financial benefits, i.e., the "benefit" to not disclose a loss that is supposed to be disclosed to the market. However, since the FSA did not show to what extent this provision will apply, the application may distort the purpose of financial derivatives, which are often used to provide value to the customer through regulatory or tax arbitrage.

189. Interview with Darryl Kaneko, Esq., Head of the Compliance Department, Deutsche Securities, Tokyo, December 3, 2000.

One month later, in June 1999, BNP Paribas Securities (Japan) Ltd. also incurred administrative action, including a one week suspension of the business of certain groups, a three day suspension of equity brokerage business. Additionally, BNP Paribas was required to submit a plan to create compliance and internal control procedures.[190] The same description was given regarding window-dressing transactions as was given in the Deutsche Securities case. In September 2000, WestLB Securities Pacific received an administrative sanction, including suspension of certain business groups for three weeks, and a prohibition against commencing a credit derivatives business for two months.[191] The regulatory release said that the company had provided a scheme to insurance companies that would enable them to improve their apparent solvency margin ratio, without actually improving their capability to pay out on policies. The SESC also made a recommendation to the FSA for administrative sanctions, concluding that such activity would be a solicitation of securities business by promising to provide a special benefit to a customer. In April 2001, the Canada Commerce Bank (Tokyo Branch) incurred a one week suspension of its Equity Derivatives Group, and was ordered to establish a sound compliance structure. The regulator stated, among other reasons, that the bank did not have a sufficient compliance structure, in that the bank structured and executed an inappropriate transaction that may have been used by its client to intentionally adjust accounting.[192]

### 3. The Reason for the Severity of the Sanctions

Judging only from the FSA statement, it is unclear as to which of the three points (window dressing, firewall violations or obstruction of inspection) concerned the FSA the most in regards to CSFP's conduct. Banking Law Articles 63 and 64, to which the FSA referred as the authority for administrative action for obstruction of inspection, limits administrative action to a fine up to 500,000 yen.[193] The FSA referred to Article 27 as the

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190. *See* FSA Press Release, *On the Administrative Action against BNP Paribas Securities Tokyo Branch*, June 9, 2000, available at <http://www.fsa.go.jp/p_fsa/news/news-j.html> (visited on April 15, 2001).

191. *See* FSA Press Release, *On the Administrative Action against West LB Securities, Tokyo Branch*, Sept. 26, 2000, available at <http://www.fsa.go.jp/news/news.html> (visited on April 15, 2001).

192. *See* FSA Press Release, *On the Administrative Action against Canada Commerce Bank, Tokyo Branch*, April 13, 2001, available at <http://www.fsa.go.jp/news/news.html> (visited on April 15, 2001).

193. When DKB obstructed the regulator's inspection, the only sanction the MOF assessed it was an order to improve its compliance system. *See MOF Files Criminal Complaint Against Dai-Ichi Kangyo Bank*, MAINICHI DAILY NEWS, July 26, 1997, at 1); Anthony Rowley, *Nomura, DKB*

authority for administrative action for selling window-dressing products, which provides,

> When a bank has violated laws and regulations, its articles of incorporation, or dispositions of the Minister of Finance based on laws and regulations, or engaged in an act detrimental to public interests, the Minister of Finance can order the said bank that it suspend its business totally or in part or that its directors or auditors resign, or can cancel the license.... [194]

Article 27 is the only one the statement refers to that deals with a potential license revocation, and thus, from the statement alone, it looks as if the license revocation came from the window-dressing product.

If we consider the level of sanctions other brokers received, however, there is a strong indication that the sanctions for the CSFB group mainly arose from their evasion of the inspection.[195] It seems to be true that CSFB was selling window-dressing products heavily in comparison with other financial institutions. However, considering what the other firms were sanctioned for, it was the window dressing products, from the FSA's perspective, that deserved suspension of the respective departments of the firm. It is makes more sense to consider that the FSA revoked CSFP's license because of systematic evasions of inspection.[196] Viewing this incident from that perspective, it is probably not as sensational as it first sounds. The incident even cast doubt over what the FSA cares about, and to what extent. One Japanese lawyer knowledgeable about the regulatory situation in Japan described the CSFB incident as an unfortunate case, since the group started to shred documents without taking the opportunity to discuss with the regulator the legitimacy of the product they were selling.

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*Punished; Police Raid Yamaichi*, BUS. TIMES (Singapore), July 31, 1997, at 1.

194. Translation from <http://www.japanlaw.com/banking/1981.htm> (visited on April 15, 2001) with additional translation by the author.

195. It was reported that "a source close to the CSFB case" said that "it's like if you were stopped for driving 15 miles per hour over the speed limit. No big deal. Just a ticket. But when you get out of the car and punch the cop. Suddenly you have a big problem." Lindorff, *supra* note 63.

196. One thing worth noting is that the FSA only revoked CSFP's license. CSFB still maintains its securities, trust bank and investment management subsidiaries. All the group had to do to continue business in Japan was to move staff from its banking company to its securities company. However, the revocation seriously affected its reputation, and Japanese customers may not prefer to deal with the group. The sanction was relatively mild considering the structure of the group, and comparing the sanctions against those imposed upon Daiwa Bank in New York, when what the CSFB group did in Japan was more serious than what Daiwa did in the U.S. *See* William Hall, *CSFB Edges Closer to the Global Banking Super-League: Japanese Problems are Unlikely to Cause Lasting Damage to Group Having Best Year in its History*, FIN. TIMES, July 15, 1999, at 23; *see also* KINYU KANTOKU CHOU [FINANCIAL SUPERVISORY AGENCY], *supra* note 37, at 185-193.

### B. *Significance of the CSFB Incident*

The CSFB incident was a landmark decision, since it demonstrated an improvement of the regulatory system under the FSA. First, the FSA proved that its ability to inspect has improved substantially. Second, it proved that what it cares about is a fair market, i.e., investor protection. This change is a major shift in regulatory attitudes, suitable for the current environment in Japan.

The FSA boasted about its achievement regarding inspection in its annual report.[197] Their achievement was partly due to temporary inspectors who were knowledgeable about the type of the product they were examining. The other factor was that the FSA conducted inspection on a group basis, not entity-by-entity basis. Although foreign financial institutions usually managed several companies in a unified manner under one holding company, that concept was not familiar in Japan. Bank holding companies were not allowed in the country until 1998.[198] And since there was no such thing as a financial group under one holding company, the regulator was not able to understand the full picture of the management of the group. However, in this case, the inspectors clarified the complicated management structure, tangled reporting lines, and confusing entity set-ups.

The handling of the matter represented a major shift in attitudes. Although the interpretation of the window-dressing products by the MOF was not clear, one case strongly suggests that the MOF was not ready to enforce laws against loss-concealing transactions. In late 1997, the fourth-largest securities firm in Japan, Yamaichi Securities, decided to shut down its business. After the collapse, it was discovered that the firm incurred JPY 291.4 billion in losses from providing *tobashi* (loss-transfer)[199] transactions.[200] An in-house report at the firm asserted that the firm executives were told by MOF officials to transfer the losses abroad, and that officials subsequently told the executive to settle the problem in a private manner, since "[the total loss] is not much for Yamaichi. Sort it out somehow as quickly as possible."[201] The former chief of the Securities

197. *See FSA Annual Report for the Fiscal Year of Heisei 11 (1999) Section 4*, available at <http://www.fsa.go.jp/p_fsa/news/newsj/f-20000627-0a.html> (visited on April 15, 2001).

198. *See* Andrew H. Thorson and Frank Siegfanz, *The 1997 Deregulation Of Japan's Holding Companies*, 8 PAC. RIM L. & POL'Y 261 (1999).

199. A *tobashi* transaction transfers depreciated assets such as stock to another company at face value, with a promise to purchase it back later at a compensational price. These transactions were arranged by securities companies between their clients, and often the securities company itself promised to purchase the depreciated asset if the original holder was not able to do so. *See* Gillian Tett, *Tobashi Refined as a Way to Hide Embarrassing Losses*, FIN. TIMES, November 24, 1997, at 2.

200. *See Watchdog Body Wants Yamaichi Punished*, THE DAILY YOMIURI, April 3, 1998, at 14.

201. *Yamaichi Report Reveals Events Leading to Collapse*, THE DAILY YOMIURI, April 17, 1998,

Bureau of the MOF testified in the trial of the Yamaichi chairman that he gave the option to the executive to continue the practice, in order to prevent the entire securities industry from suffering when the problem was revealed.[202]

However, through the abovementioned series of administrative actions, it became clear that the FSA would take almost the opposite view from the MOF on the matter. The new regulator viewed the window-dressing transactions as "extremely inappropriate from the standpoint of adequate disclosure of its clients' financial conditions,"[203] inappropriate enough to trigger administrative action. This is a plausible shift, more suitable for the current Japanese financial market. Japan needed confidence in the financial market to attract more investors, and confidence in the financial institutions to gain more customers. Lack of sufficient disclosure was said to be one of the largest reasons for the Japanese financial market not being active (compared with the markets in New York or London), and the government was already stressing the importance of adequate disclosure and a fair market.[204] The FSA confirmed through its actions that it would take the same stance.

### *C. Lessons of the CSFB Incident*

The benefit of the administrative action was major. However, there still are lessons that the regulator should learn from the issues involved in the incident. One issue is predictability for law enforcement, and another is the capability of the current regulator to communicate with the financial institutions under current laws.

#### 1. Predictability

There was a huge debate among foreign financial institutions in Japan as to the appropriateness of the action of the FSA in response to the CSFB incident. Many people argued that the actions taken by the FSA were unfair, since the regulator was applying a new rule retroactively.[205] It is not correct to say that there were no rules prohibiting the products, since there

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at 2.

202. *See Ex-Bureaucrat: Ministry Supported "Tobashi,"* THE DAILY YOMIURI, June 16, 1999, at 2.

203. *See* FSA Press Release, *supra* note 174.

204. *See* Carla Rapoport, *Japanese Call for Financial Reform*, FIN. TIMES, June 7, 1985, at 20; Emiko Terazono, *Interest in Japan as Financial Centre Wanes*, FIN. TIMES, March 30, 1993, at 31.

205. *See* David I. Walker, *The Casablanca Paradigm: Regulatory Risk in the Asian Financial Derivatives Markets*, 5 STAN. J. L. BUS. & FIN. 1 (1999).

was a law that could govern those products, albeit a vague one, at the time of the conduct. It seems true, however, that the regulator has been changing views on that issue, or at least, was unclear in its attitude, causing unpredictability in the market. The FSA did not send a clear message that it would not allow window-dressing transactions until it conducted the inspection of CSFB. The regulator's change of attitude, and inability to clarify the changed attitude, may cause unpredictability.

As discussed in the previous section, there seems to have been a change of attitude as the regulatory focus changed from the MOF to the FSA in 1998. Some brokers argued that the new stricter view was applied retroactively,[206] and that a broker sold a product acknowledged by the MOF[207] that was banned by the FSA because it was "extremely harmful." Although the FSA is a newly created regulator, with a new name, new chief, and new building, most of the FSA officers were from the MOF, and the two bureaus worked closely with each other.[208] However, there is no point for the broker to argue that it was treated unfavorably, especially if it relied on an unofficial and ambiguous opinion without evaluating whether there was any possibility that the regulator would change its position. This incident did create a concern of predictability in the market. The regulator first relied on a very broad provision, which was accused of being too vague, then changed the applicable provision to the prohibition against soliciting customers by promising special benefits, which made the market suspicious that every new product, especially derivatives,[209] had the potential to be the next product the FSA would want to ban.

This is an issue that cannot be solved by inspection. Communication between the regulator and financial institutions will solve the issue to some extent. When there is an unclear rule, the rule should be clarified through communication. Predictability could be achieved by having a clearer rule, which could be achieved by adopting a prompt amendment of the law. But it also could be done through formal communication between the regulator and the market. In either case, the procedure should be prompt and flexible. Systems such as a United States-style no-action letter (now being discussed) may be a candidate for this type of communication.

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206. *See* Tett, *supra* note 179, at 8.

207. *See Did Finance Ministry Help NCB Rig Accounts?* THE DAILY YOMIURI, July 28, 1999, at 3; Tett, *supra* note 179, at 8.

208. *See Financial Watchdog*, MAINICHI DAILY NEWS, June 25, 1998, at 2; *New Finance Watchdog Faces Credibility Hurdle From Get-Go*, THE JAPAN TIMES, June 20, 1998.

209. Derivatives are often used for arbitrage when there are regulatory, tax, accounting, or investment restrictions. For more on the use of derivatives and their potential to capture profit or reduce costs because of differential regulations or laws, *see* Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 IOWA J. CORP. L. 211 227 (1997).

There still is a need for informal and private communication between the regulator and the financial institutions. When there is a question of law, it usually means there is a new product, or new activity. An important part of the skill of a financial institution is the creation of new products that will meet the demands of market and client conditions. Most of the time, financial institutions will not want to disclose the whole structure of the product to the market, since unlike manufacturers, it is relatively easy for competitor institutions to create the same product. At first, financial institutions tried to have private communication with the regulator. Being more cautious of the legality of their activity, they tried to discuss possible interpretations of the laws and regulations with the regulator. However, the regulator stopped discussing and consulting with financial institutions,[210] aiming for a "transparent and fair financial regulation pursuant to clear rules." After abolishing the old methods of unofficial communication, the regulator is not yet ready to give guidance to financial institutions. What the regulator is ready to say to financial institutions at the moment is simply to "comply with what is written in the law," and not to advise on anything beyond that. There is a need for a new unofficial and fair method of communication between the regulator and the financial institutions.

This is not an issue only for foreign financial institutions. When the regulator is trying to avoid secret dealings with, and avoid giving detailed instructions on how to do business to, Japanese financial institutions, there is a possibility that Japanese firms will soon be in the position of CSFB or other foreign firms. If there is no effective means of communication to ensure predictability of the application of law, it will seriously affect the whole Japanese financial industry.

### 2. Capability of Supervision

One possible reason the incident happened was that the regulator did not actually understand the exact transaction, or the current trends in the market. When the convoy system was working, the MOF was basically able to obtain the information it needed to regulate. Even if it did nothing, financial institutions came to MOF officials with information. But even under the convoy regime, the MOF was not able to obtain sufficient information on some issues. The regulator had to go through intensive inspection of Japanese banks to get a whole picture of the bad loans. With the additional activity of foreign institutions that the regulator did not have

210. *See* WuDunn, *supra* note 122, at 4.

close communications with, it is likely that the regulators were not aware of what foreign financial institutions were doing, such as engaging in window-dressing transactions. It is unclear whether the domestic financial institutions discussed the usage of such products with the regulator, but there is a strong possibility that the MOF was not actually aware of this product. Now that the convoy system has collapsed and all other communication channels have been forced to shut down, the financial regulator has only limited ways to obtain information from domestic financial institutions. One question presented by the CSFB incident is how the FSA will deal with this situation.

Gathering information from financial institutions is done on a daily basis through the supervisory process. If information gathering is not done effectively, the whole supervisory process is not working. To have transparent and fair supervision, it is necessary to have the knowledge and resources to accomplish that end. The FSA supervisory department in charge of the process seems to lack both. While the inspection department is gaining more resources and knowledge on the financial market it regulates, it seems that the supervisory department is still facing a resource issue. According to the FSA, they will have 360 staffers in the inspection department (for a total of 482, together with members of SESC) in fiscal year 2001.[211] On the other hand, there are only 144 in the supervisory department, which is in charge of supervising the whole financial industry. Considering the current situation, where only one or two officials have to deal with all foreign securities firms in Japan (which are coming up with new products and potentially creating trouble every day), the officials can hardly catch up. It is almost impossible to take the next step, and gain knowledge through collecting current market information.

As always, there are budgetary concerns. However, having something that will work entails cost, and the government and the people of Japan have to bear that cost. There needs to be an appropriate allocation of resources. One option may be to have temporary staff culled from the financial sector. There may be an argument that this would create another cozy relationship between supervisors and the financial institutions. However, the problem should have less significance where the regulator has less authority to approve new business, and when inspection is working. Also, having temporary staff in supervisory positions should create less conflict than it would for the inspection world.

211. *See supra* note 151.

This issue of supervision, together with the issue of providing effective communication routes to the financial institutions, is the most urgent issue that needs to be resolved for current financial regulations.

## VI. CONCLUSION

This note has tried to find a method for how a financial regulator should deal with financial institutions to ensure compliance with applicable laws and regulations. This method is unique from country to country, at a given specific time. The Japanese government has said that a "free, fair and global" market is the goal for financial reformation. The regulator is trying to follow the same principle for financial regulation. It seems true that the environment and the attitude of the regulator are becoming increasingly fair in terms of interpretation and application of laws and regulations. But whether it is becoming global is yet to be seen. Unlike "free and fair," there is no objective standard for "global." Global should mean a market can accept and attract investors globally, and the method of doing that depends on the market. Since each market is unique in its environment, setup, history, social background, etc., there is no single method for achieving "globalization." Although Japan has adopted many legislative and regulatory methods from the United States, simply importing another "U.S. style" will not create a "global" outcome. The U.S. style will be given a different meaning in a new environment. Thus, it is necessary to create a method that will have "globally" understandable effects in accordance with the particular situation of a market, and the nature of the main players in that market. It has been observed that the Japanese regulator and Japanese financial institutions have too close and closed a relationship, and insufficient resources for inspection derive from that relationship. Now that Japanese financial regulators are trying to stop having such a close relationship with financial institutions, and have proved they have the ability to discover a problem through inspection to a certain extent, it seems to be time to focus more on developing sufficient and appropriate communication with financial institutions. The Japanese financial market has developed a friendly and cooperative relationship between the regulator and financial institutions, due to a unique social and historical background—so maybe it is best to take advantage of that. As the Chairman of the United States Securities and Exchange Commission ("SEC") has stated, securities firms

themselves are increasingly important to the SEC in order to enforce the securities law.[212] The same should apply to Japanese regulators.

While the style of regulation is affected by the compliance situation of financial institutions, and it should be designed in line with each situation, the financial institutions' approach to compliance should also be designed in line with the particular regulatory situation. Compliance means compliance with the rules, and the definition of rules may vary from jurisdiction to jurisdiction. In some jurisdictions, where there is a clear law, and everything outside of the law is permitted, compliance clearly means compliance with laws. However, although regulation in Japan is changing, there still remains ambiguity in the law allowing for a broad range of interpretation—but financial institutions will be subject to punishment if the interpretation is incorrect. Apart from the question as to whether such a situation should be changed so that everyone will be able to participate equally, this is a question faced by foreign financial institutions during past years, and the question all other Japanese financial institutions will face from now on. CSFB failed in interpreting the law, and the company was thus told that it was not in compliance with a law that says financial institutions may not do business in a way that is "detrimental to the public interest."

In Japan, the word compliance is often defined in the institutional context as being in compliance with laws, regulations, morals, ethics, and social norms.[213] It is unique that compliance with moral, ethical, and social norms should be added to compliance standards. This definition presents one answer to the question. But what to do when laws and regulations are ambiguous? When there is an ambiguous law, and there is room for interpretation, narrow or broad, the least risky (but not overly conservative) method of interpretation is to interpret the laws in line with moral, ethical, and social norms. Practically speaking, when there is a vague law, a financial institution should take a conservative view, if the end result seems to be unfair, or harmful to a third party. It can take an aggressive view if the end result will have no impact on anyone. In other words, a financial institution should not take actions that will affect its reputation.[214] This definition itself is rather vague, and may have more than one answer to one

212. *See* Walsh, *supra* note 10, at 166.

213. *See supra* note 161.

214. "[Compliance objectives] should be met in order to protect the bank's franchise and reputation." *See* Basle Committee on Banking Supervision, *Framework for Internal Control Systems in Banking Organizations*, Sept. 1998, at 9 available at <http://www.bis.org/publ/bcbs40.htm> (visited on April 4, 2001). *See also* Principle 3 of *Principles for the Assessment of Internal Control Systems* in the same document at 3; Kaneko, supra note 11, at 18.

question. But it will provide a sufficiently solid core for a company's compliance structure.