Problems of Financial Instruments and Exchange Act

Mitsuo KONDO

Financial Instruments and Exchange Act is expected to play many roles at the present day. But it is difficult to define the proper mission of this act. The purpose of this symposium is to consider contemporary problems of this act. Though there are many problems to discuss, this symposium concentrates on the five important subjects.

Reexamination of the regulations for the Stock Purchase and TOB

Masashi SHITANI

This presentation addresses the regulations for the stock purchase and TOB in Japan. There are listed and unlisted corporations. This report puts the former on the mind. But this comment will influence the latter’s problems. As a rule, Financial Instruments and Exchange Act distinguishes stock trading in the market and stock trading outside the market. Market transactions have been entrusted to the rule of the securities exchange. This report points out the problem of such correspondence compared with the restriction of Europe. The problem includes the protection of the individual investor and minority stockholders. The securities exchange cannot defend minority stockholders’ profits well.

As for the transaction outside the market, the existing law restriction is not enough. If a person purchases such that the person exceeds 1/3 of the right to votes, it is necessary to follow the TOB rule of Financial Instruments and Exchange Law (one third rule). If a person purchases such that the person exceeds 1/3 of the right to votes through the share issuance by the corporation, he or she may do it by escaping the application of one third rule. Such a distinction completely lacks the rationality when seeing from the aspect of the stockholder protection. The predominant stockholder might exploit the minority stockholders.

The essence of my opinion is as follows. The acquisition by stock trading should acquire the stocks that exceed, for instance, 1/3 of the right to votes based on the TOB rule of Financial Instruments and Exchange Law, and the same restriction be done without distinguishing the inside and outside of the market. The stockholder protection by the Corporate Law is not enough when the predominant stockholder appears or there is a reshuffle. It is necessary to give the minority stockholders the chance to sell the stocks. When they achieve the M&A by the sacrifice of the minority stockholder, it is not fair at all.

Of course, the problem that should be examined has been left. For instance,
whether it is necessary to admit the exercise of the right to vote about the stocks acquired illegal? Should it actually make the application of the TOB restriction to market transactions a restriction of what content because it is impossible? If a person purchases such that the person exceeds 1/3 of the right to votes through the share issuance by the corporation, to do TOB after the fact, should it impose the obligation on him or her?

In addition, it is necessary to gaze at the discussion about the Corporate Law revision.

**Damages Caused by Misstatements**

*Yoshio SHIOMI*

When we overview the various regulations regarding the effects of issuer liability in the Financial Instruments and Exchange Act (FIEA) on the basis of theories of tort damages, it turns out that although various techniques are used, they are essentially based on the idea of recovering damages to the victim’s current total assets.

That is to say, the regulations of FIEA articles 19 and 21-2 related to the effects of issuer liability, while introducing special substantive and presumption rules on the meaning of damage, provide rules to the issuer for reducing or excluding liability which consider causes that stem from circumstances occurring after the acquisition of securities. These rules are provided in order to avoid difficulties of relieving the acquirer, which are rooted in problems of proof of the damages was caused by misstatements. In addition, the regulations in the above articles also provide rules in order to relieve the issuer’s burden of proving condition for reducing or excluding liability. Thus, a balance between acquirer and issuer is achieved concerning the issue of allegation and proof of damages and the amount of these damages. Furthermore, in this case, theories on rescissory and out-of-pocket damages within theories of tort damages, are not carried through and have been largely amended.

In other words, if articles 19 and 21-2 are seen in the light of the substantive law, and not from the point of view of the Evidence Law or of the burden of proof, then the focus becomes one where not only factors occurring at the stage of acquisition but also factors of fluctuation in the acquirer’s assets, since the time of acquisition until the present, as well as the time when the fluctuation affected the acquirer’s assets are taken into consideration. In such a focus, the factors considered comprise all of the following: factors associated with the acquirer (e.g., presence or absence of disposition after acquisition, the amount of the disposition), factors associated with the issuer (such as the holding status of securities, company scandals, deterioration of business, and other factors which involve the issuer besides misstatements), and neutral factors (e.g., other holder’s investment behavior, the dissemination of unfounded rumors, delisting measures).
Thus, in articles 19 and 21-2 damages is assessed in the light of its proximate cause to misstatements and other factors by taking into account various factors of fluctuation in the acquirer's assets that occurred until the present situation (in the case of a legal proceeding, this is the time of conclusion of oral argument).

Within the scope of this understanding, theories that regard the acquisition of securities itself (rescissory damages) or the acquisition of securities at high cost (out-of-pocket damages) as damages are merely tools to keep the balance between acquirer and issuer in matters of proof. Consequently, even though regulations in articles 19 and 21-2 are at variance with the conceptions of rescissory and out-of-pocket damages, as long as they are reasonable as rules in the Evidence Law, there should not be any problem. The fact, however, that the compensation for damages caused by misstatements and the like is not clearly defined on paper may be due to the following reason. It is the gap that lies in between the previous commentaries, which seems to explain that article 19 adopts a Saldotheorie on the basis of theory on rescissory damages and article 21-2 on the basis of theory on out-of-pocket damages, and the actual state of affairs where, as far as the regulations in these articles are concerned, a approach is taken by adopting a Saldotheorie which is based on the conception of damages incurred to the total assets at the present time.

**The Structure of Regulation on Insider Trading**

*Masahiro MAEDA*

The current structure of the regulation on insider trading in Japan, which was introduced by the 1988 Amendment to the Securities Exchange Act ("the Act") of 1988, is extremely formal and concrete, as a result of emphasis on the requirement for clarity as insider trading. Such regulation cannot cover all the insider trading that should be regulated. Typically, as for material facts the coverage by the catch-all-clause in the current Act can not extend to all the facts that could have significant influence on the investment decisions made by general investors. Also, as for the extent of insiders, only the first tippee is subject to the regulation under the current Act. The existence of these regulatory gaps will seriously undermine the public trust in the integrity of the securities market. In addition, as compared to the systems in the United States and EU countries, our current regulation is found to be monstrously complicated.

We should change the formal regulatory structure of existing regulation to the abstract and simple structure. It is true that the scope of regulation must be clear by law as far as the regulation with criminal sanctions is concerned. But as far as the regulation with the administrative surcharge ("Kacho-Kin") system is concerned, which was introduced by the 2004 Amendment to the Act, it is not necessary to be excessively conscious of the requirement for clarity as insider trading. In connection with the surcharge system, the current structure of regulation on
insider trading should be changed to more abstract and simple one.

**Regulation separating banking and securities business**

Yasuhiro KAWAGUCHI

Japan had adopted a policy of separating the banking and securities business. Article 33 of the Financial Instruments Exchange Act in principle prohibits financial institutions, including commercial banks, from engaging in the securities business. This separating system has been mitigated by several financial reforms. Banks can hold securities firms as subsidiaries and also securities firms can hold bank subsidiaries after 1992 amendments. At present, financial holding companies can also hold several types of financial business companies as subsidiaries. This became possible with the lifting of the ban on pure holding companies in the Antimonopoly Act. Under the law currently in force, banks and securities firms, can form corporate group where they are related by a financial holding company that is parent company to them all.

On the other hand, banks can engage in specified securities business. For example, banks can sell national bonds and other public bonds to their customers. Conventionally banks had been prohibited from selling financial instruments bearing market risk. Banks could only sell guaranteed financial instruments such as deposits. But this conservative policy has changed, namely the scope of business that banks could undertake expanded greatly to include the sales of mutual funds in 1992. This financial reform paved the way for new securities business to the banking industry. There is no reasonable reason to prohibit banks from engaging securities brokerage business any more.

Strict regulations lowered the competitive advantage of Japanese financial institutions relative to U.S. and European financial groups. Therefore “fire wall” regulations among banks and securities firms mitigated in 2008. In particular, the regulations forbidding multiple posts at these institutions (for example, between parent bank and securities subsidiary) were repealed. The 2008 reforms also relaxed the rules regarding exchanging customers’ private information between banks and related securities firm. It is well known that Japanese banks have a large degree of influence over companies, and in this round of reforms, making use of this influential has been substantially deregulated.

Compared with the law ten years ago, the barriers for banks and security firms have all been lowered. Under holding company system, Japanese financial group can provide variety of financial instruments, from deposit to stock, to their customers via their individual subsidiaries. However banks by themselves still cannot engage in securities business. Whether mitigating this restriction depends on the risk to bank soundness. Stock brokerage business will not damage bank soundness because investors shall bear their investment risk. On the contrary, securities dealing and securities underwriting will damage bank soundness. These
risky business should be provided by out-side of the banks, i.e. securities affiliate of banks.

*Enforcement of Law for Investor Protections*

_Etsuro KURONUMA_

This presentation deals with three subjects. First, what kinds of interpretations are needed in order to enlarge applicable scope of Financial Instruments and Exchange Act (FIEA) for investor protections? Second, what kind of legislation is needed in order for Civil Money Penalties in FIEA to be distributed to the victims of securities frauds? Third, what kinds of law enforcement means should be given to Financial Services Agency of Japan (FSA) in order to prevent illegal acts in their early stages?

2006 Amendments of FIEA introduced a catch-all-definition of securities, which made FIEA provisions to be applied to broader range of securities frauds. In the presentation, I explore applicable scopes of FIEA, other financial regulations, and regulations for consumer protections.

Civil Money Penalties from FIEA violators are paid not to the victims of the violators, but to the Treasury. In the area of other financial crimes, there are some legal systems which distribute money to the victims of such crimes. I compare Civil Money Penalties in FIEA with such legal systems, and list issues to be overcome in order to construct distribution system of Civil Money Penalties as follows. First, the purpose of Civil Money Penalties is the prevention of financial crime rather than compensating victims. However, such a purpose is not an obstacle in introducing distribution system, because distributing money distracted from offenders does not hinder deterrent purpose of the penalties. Second, Civil Money Penalties are ordered regardless of violators' culpabilities. Then we should make clear the relationship between victims' claims against violators and violators' obligations toward Treasury. In general, investors who received money from Civil Money Penalties are not obliged to return it to the violator even if the investor is in fact not qualified for the claim of damages. Third, while Civil Money Penalties are constructed as an administrative procedure, it seems possible for us to design money distributing process either as an administrative one or as a court procedure. Although court procedure can freeze assets of violators, administrative procedure is quick and less costly when the violator admits her crime. Each procedure should be chosen by FSA according to the nature and complexity of the case.

FSA has a right to file suits for injunctive reliefs against violators of FIEA, but this right has rarely been used. However, in order to prevent illegal acts in their early stage, FSA should not hesitate to use this means. In addition, cease-and-desist order against any person who violates FIEA in administrative proceedings should be introduced to help deter violations.