

# ARTICLES

## THE FORMATION AND TRANSFORMATION OF SECURITIES LAW IN JAPAN: FROM THE BUBBLE TO THE BIG BANG

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### ABSTRACT

It has been a tumultuous decade for Japanese securities markets. The collapse of the Bubble and advent of the Big Bang have reshaped the markets and spurred significant foreign investment. The newspapers are filled with accounts of mergers, acquisitions, and bankruptcies.

Less widely reported, but equally important, has been the dramatic shift in Japanese securities law. Prior to the 1990s, private enforcement of Japanese securities law was “virtually non-existent.” The collapse of the Bubble, a regulatory vacuum and unsatisfactory alternative dispute resolution changed this. There has been a litigation explosion resulting in new judicial norms. A proactive judiciary has imposed duties on securities companies and created private causes of action for investors without basis or counterpart in the Japanese Securities Exchange Law. These judicial norms, more than adminis-

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trative or private norms, have come to regulate the retail securities markets.

As with previous periods of judicial activism, the central government has stepped in with new legislation. However, in contrast to earlier retrenchments that removed disputes from the purview of the judiciary, the Diet has codified the new private causes of action and reinforced the role of the judiciary.

The changes in Japanese securities law are illustrative of a remarkable shift in Japanese law and present an opportunity to better understand the changing roles of administrative agencies and the judiciary in Japan. These changes also present opportunities, as well as hidden pitfalls, for foreign financial institutions operating in Japan. This paper explores an important area and period of Japanese law that has thus far received little attention.

## TABLE OF CONTENTS

I. PUBLIC LAW AND SELECTIVE ENFORCEMENT .....	6
A. THE SECURITIES EXCHANGE AND SURVEILLANCE COMMISSION .....	7
1. <i>Its Origins, Organization, and Authority</i> ...	7
2. <i>SESC Accusations and Recommendations</i> ..	12
3. <i>Inspections and Problems "Recognized"</i> ...	19
B. JAPAN SECURITIES DEALERS ASSOCIATION ....	24
1. <i>Its Origins, Organization, and Authority</i> ...	24
2. <i>JSDA Sanctions and Problems "Recognized"</i> .....	27
C. ALTERNATIVE DISPUTE RESOLUTION .....	32
II. PRIVATE LAW AND A "LITIGATION EXPLOSION" .....	34
A. SECURITIES FRAUD AS A TORT .....	36
B. THE DUTY NOT TO MISLEAD .....	39
1. <i>Traditional Analysis</i> .....	40
2. <i>Emphasis on the Duty to Explain</i> .....	42
C. THE DUTY NOT TO SOLICIT UNSUITABLE TRANSACTIONS .....	45
1. <i>Traditional Analysis</i> .....	45
2. <i>Emphasis on the Duty to Explain</i> .....	48
D. THE DUTY TO EXPLAIN .....	53
1. <i>From Disclosure to the Duty to Explain</i> ...	53
2. <i>The Duty to Explain—An Objective Standard</i> .....	56
3. <i>The Duty to Explain—A Subjective Standard</i> .....	58
4. <i>Beyond the Duty to Explain</i> .....	61

III. RECENT LEGISLATION AND NEW PRIVATE RIGHTS OF ACTION .....	67
A. THE FINANCIAL PRODUCTS SALES ACT.....	67
B. THE CONSUMER CONTRACT ACT .....	74
IV. BROADER IMPLICATIONS .....	79
A. JUDICIAL ACTIVITY .....	79
B. REGULATORY PASSIVITY .....	85
V. CONCLUSION.....	90

The collapse of the Bubble<sup>1</sup> and the institution of Big Bang reforms<sup>2</sup> have brought about dramatic changes in the function and regulation of the securities markets. In 1997, after-hours trading for large lot transactions was introduced.<sup>3</sup> In 1998, off-exchange trading was permitted, the licensing system for securities companies was replaced by a registration system, and banks and insurance companies were allowed to sell investment trusts over-the-counter.<sup>4</sup> In 1999, brokerage commissions were deregulated.<sup>5</sup> The same year, the Tokyo Stock Exchange relaxed standards to increase the number of initial public offerings and

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1. In 1989 the Tokyo Stock Exchange had a market value of \$4.3 trillion and was the largest in the world having surpassed even that of the New York Stock Exchange. In 1991 the Bubble burst and by 1995 the market value of the Tokyo exchange had declined to \$3.6 trillion, or roughly 60% of the New York Stock Exchange. See *Sekai no Shuyō Kabushiki Shijō*, ASAHI SHINBUN CHOKAN, Oct. 8, 1996, at 13.

2. The Japanese "Big Bang," a proposal to "revolutionize" the financial services industry in Japan, was announced by then Prime Minister Ryutaro Hashimoto in November 1996. The creation of "free, open and global" markets was its goal. See *U.S. Firms Benefit from Japan's 'Big Bang'*, NATIONAL LAW JOURNAL, Aug. 25, 1997, at B12; Hideyuki Aoki & Hiroshi Hirai, *Foreign Firms Mixed Over 'Big Bang'*, THE DAILY YOMIURI, Sept. 2, 1997, at 16.

3. *More Investors Opting to Trade Stocks Online*, THE DAILY YOMIURI, June 5, 1999, at 12.

4. *Big Bang Reforms Allow Trusts to be Sold Over the Counter*, THE DAILY YOMIURI, Dec. 2, 1998, at 12; *DKB Enjoying Rapid Growth in Investment Trust Operations*, THE DAILY YOMIURI, Mar. 7, 2000, at 9. Investment trusts are similar to mutual funds in the U.S., but operate as trusts rather than in company form. See Masaki Yagu, *Securities Activities of Japanese Banks Under the 1993 Japanese Financial System Reform*, 15 J. INTL. L. BUS. 303, 345 (1994).

5. Fees for large lot transactions were deregulated in April with brokerages free to set commission rates for all other transactions beginning October 1999. Terumitsu Otsu, *On-line Brokerages Attracting Wide Range of New Investors*, THE DAILY YOMIURI, Dec. 7, 1999, at 9; SHOKEN TORIHIKI TO KANSHI IINKAI, SHOKEN TORIHIKI TO KANSHI IINKAI NO KATSUDO JOKYO, 7(2) (1999) Securities and Exchange Surveillance Commission, SECURITIES AND EXCHANGE SURVEILLANCE COMMISSION ANNUAL REPORT, 7(2) (1999) [hereinafter SESC, 1999 ANNUAL REPORT.] available at <http://www.fsa.go.jp/sesc/report/report-j.html> (last visited Dec. 5, 2000). As page numbers are not provided in the 1999 and 2000 Annual Reports downloaded from the Internet, citations will be to chapter and section as is done in the original. Citations to the Annual Reports available in print, 1993 to 1998, will be to the relevant page number.

established the Mothers Exchange, a new market for emerging and technology based stocks.<sup>6</sup> Shortly thereafter, Nasdaq and Softbank concluded an agreement with the Osaka Stock Exchange to create Nasdaq Japan, a market to rival the Mothers Exchange.<sup>7</sup>

Deregulation combined with low interest rates and an enormous potential market have brought in foreign institutions and investment that have reshaped the market.<sup>8</sup> In 1998, Merrill Lynch Japan invested approximately \$200 million, absorbing personnel and branches from the failed Yamaichi Securities Company.<sup>9</sup> That same year, the Fidelity Group started direct telephone sales.<sup>10</sup> In 1999, Charles Schwab and Co. established a joint venture with Tokio Marine and Fire Insurance Co. to buy and sell stocks and investment trusts via the internet, telephone and over-the-counter.<sup>11</sup> In 2000, Citigroup doubled its stake in

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6. The new standards permit the listing of companies that pay no dividends and relaxed both corporate profit requirements as well as requirements for the number of shares listed. Sixty-six companies listed on the Tokyo Stock Exchange in 1999, exceeding a previous high of fifty-nine in 1996. See *TSE Listings to Hit Record High*, THE DAILY YOMIURI, Nov. 25, 1999, at 16. The Mothers Exchange began November 1999 and as of August, 2000 had sixteen stocks listed. See SESC, 2000 ANNUAL REPORT 7(2), available at <http://www.fsa.go.jp/sesc/report/report-j.html> (last visited Dec. 5, 2000).

7. *Nasdaq Japan Operation to be Entrusted to OSE*, THE DAILY YOMIURI, Nov. 6, 1999, at 12. As of August 2000, Nasdaq Japan also had sixteen stocks listed. See SESC, 2000 ANNUAL REPORT 7(2), *supra* note 6.

8. Japanese personal financial assets are believed to be worth 1.2 quadrillion yen. However, 55% of all financial assets in Japan are in the form of savings, as opposed to 15% in the U.S. Japanese investment trusts account for only 3% of individual assets in Japan, far below the 10% of personal assets found in mutual funds in the U.S. See Ikuo Anai, *Banking Trailblazer Nurtures Nest Eggs of Patient Investors*, THE DAILY YOMIURI, Feb. 9, 1999, at 13; Terumitsu Otsu, *Reaction to Investment Trusts Changing Rapidly*, THE DAILY YOMIURI, June 9, 1998, at 13; Mami Tsukahara, *Investment Trust Market May Take Off After Big Bang*, THE DAILY YOMIURI, Mar. 3, 1998, at 17. Insolvent pension plans, the introduction of a Japanese version of 401k legislation, and outflows from savings accounts due to low interest rates are expected to change the picture. The introduction of defined contribution pension plans similar to 401k plans in the U.S. in particular has encouraged major Japanese securities companies to expand their sales networks. Nomura, Daiwa, and Nikko all increased the number of their branches in 2001. See Anai, *supra* at 13; *U.S. Analyst: Mutual Funds Have Huge Potential in Japan*, THE DAILY YOMIURI, Nov. 9, 1999, at 9; *'Nihonban 401K' dare no tame*, ASAHI SHINBUN, July 25, 1999, at 9; *Securities Firms Set to Bolster Networks*, THE NIKKEI WEEKLY, Apr. 16, 2001, at 15.

9. *Merrill Lynch Japan Expects Net Profit in 2000*, THE DAILY YOMIURI, Nov. 28, 1998, at 14.

10. Yumi Kuramitsu, *Reforms Spell Opportunity for U.S. Financial Group*, THE DAILY YOMIURI, June 16, 1998, at 21.

11. Takao Kuroi, *Charles Schwab Seeks to Obtain 500,000 clients in Japan Tie-up*, THE DAILY YOMIURI, Nov. 24, 1999, at 12.

Nikko Securities.<sup>12</sup> These firms have been joined by E\*Trade and a host of other online brokers, all seeking to capitalize on the liberalization of brokerage commissions.<sup>13</sup>

This article will address changes no less dramatic but less widely reported, changes in the creation of legal norms that regulate the securities markets and changes in the institutions that apply those norms.

In the English literature describing Japanese securities law, it has been stated that private enforcement of Japanese securities law is “virtually non-existent” and in its stead a distinctive system of administrative guidance has evolved.

Private enforcement of Japanese securities law – by plaintiffs either seeking civil damages for securities law violations or challenging MOF’s [the Ministry of Finance’s] interpretation or administration of SEL [the Securities Exchange Law] – has been virtually non-existent throughout the SEL’s history. Instead, a distinctive monitoring system for securities activities has evolved in which MOF plays a central and often dispositive role.<sup>14</sup>

In comparison to the United States, where “a judicial oak has grown from little more than a legislative acorn,” the law’s development in Japan has been described as “stunted.”<sup>15</sup>

While these statements were an accurate reflection of Japanese securities law prior to and during much of the Bubble economy, it is no longer accurate today. There have been hundreds of private securities actions in recent years while the same period has been marked by relative inaction on the part of the administrative agency now responsible for the regulation of the securities markets, the Securities and Exchange Surveillance Commission

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12. *Citigroup to Double Stake in Nikko Securities to 20%*, THE DAILY YOMIURI, Mar. 25, 2000, at 12.

13. Otsu, *On-line Brokerages Attracting Wide Range of New Investors*, *supra* note 5, at 9; Ikuo Anai, *Online Trading Boom Raises New Concerns*, THE DAILY YOMIURI, Mar. 28, 2000, at 9.

14. Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT’L L. 423, 444-45 (1994). See also Jonathan Macey & Hideki Kanda, *The Stock Exchange As a Firm: The Emergence of Close Substitutes For The New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1043 (1990) (“Unlike the U.S., there is virtually no securities fraud litigation in Japan.” Investors do not expect to obtain ex post recovery for securities fraud and hence have a higher demand than U.S. investors for monitoring by the Ministry of Finance.); Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U.L. REV. 1436 (1994) (“Precisely because of the lack of private securities litigation, such as derivative actions, in Japan, some commentators are calling on the SESC to take an active role in market monitoring.”).

15. Milhaupt, *Managing the Market*, *supra* note 14, at 457; citing *Blue Chip Stamps v. Manner Drug Stores*, 421 U.S. 723, 737 (1975), *rehearing denied*, 423 U.S. 884 (1975).

(hereinafter SESC). Both phenomena, an administrative law vacuum and a litigation explosion, have resulted in the judicial development of legal duties and theories of liability without counterpart in the United States and only an attenuated basis in either the Japanese Civil Code or securities law. Both phenomena precipitated the recent enactment of the Financial Product Sales Act and the Consumer Contract Act, new legislation that departs from previous legislative remedies in creating private rights of action for investors. The legal landscape has changed.

The structure of this article incorporates the public law/private law distinction that is the foundation of civil law legal systems.<sup>16</sup> Part I will explore the role of public law, including black letter law and its application by a succession of regulatory agencies overseeing the securities markets. It will focus on the retail market and the administrative treatment of issues that have occupied the courts. Part II will address private law as applied by the courts and the important role litigation between private parties has played in the development of new legal norms for retail financial markets. Part III will then discuss the recently enacted Financial Product Sales Act, Consumer Contract Act, and how these acts were affected by both judicial and administrative norms. Finally, Part IV will look at the broader implications of the changes in Japanese securities law that the Bubble and the Big Bang have inspired.

Looking past the newspaper headlines of new deregulation and new foreign investment, the Bubble, its collapse, and the advent of the Big Bang have precipitated significant changes in Japanese securities law. An administrative law vacuum has given rise to a surge in litigation, judicially created norms regulating the market place, and the recent recognition of private rights of action by the Diet. These changes explain Japanese securities law and Japanese securities markets as they function today. They underline the importance of judicial norms in modern Japanese society and warrant further attention.

## I. PUBLIC LAW AND SELECTIVE ENFORCEMENT

This section reviews the regulatory structure of the administrative agencies policing the securities markets, their division of authority and in some instances the lack thereof. An examination of how that authority has been exercised and how provisions of the Securities Exchange Law (hereinafter SEL) relating to the secondary market have been enforced follows. The section concludes with a discussion of the role of self-regulatory organiza-

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16. See *infra* Part II text accompanying note 174.

tions (hereinafter SROs), and attempts at self-regulation and dispute resolution.

## A. THE SECURITIES EXCHANGE AND SURVEILLANCE COMMISSION

### 1. *Its Origins, Organization, and Authority*

As early as the Edo period (1600-1868) there was a thriving futures market in rice.<sup>17</sup> It was early in the Meiji era (1868-1912), however, that stock markets were formally authorized, first with an 1874 ordinance (*jōrei*) based on the rules of the London Stock Exchange and then later with the 1893 Exchange Law, which covered securities, commodities, and bond transactions.<sup>18</sup> Stock exchanges were opened in Tokyo and Osaka, but the focus was on trading in government bonds rather than stocks.<sup>19</sup> Companies, and more importantly the *zaibatsu* (the large business conglomerates), continued to raise capital through affiliated banks.<sup>20</sup>

During World War II, the Ministry of Finance (hereinafter MOF) intervened. In 1941, they asserted jurisdiction over the securities industry. Two years later, the Exchange Law was replaced by the Japan Securities Exchange Law, which established the Japan Securities Exchange, a quasi-public corporation that replaced the nine private exchanges then in existence.<sup>21</sup> The se-

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17. Trading methods and institutional structure were highly developed and included both spot markets, providing for physical delivery of goods, and an active market for off-setting transactions, or *seisan torihiki*. See TATSUTA MISAŌ, SHŌKEN TORIHIKI HŌ I 40 (1994). See also Noda Masao, *Senzen to Sengo no Shōken Chikuseki to Shōken•Kinyū*, in SHŌKEN KEIZAI KŌZA I 54 (Nakamura Takatori ed., 1968); Mark D. West, *Symposium Empirical Research in Commercial Transactions: III. Private Ordering in Japan at the World's First Futures Exchange*, 98 MICH. L. REV. 2574, 2577-85 (2000).

18. Kawamura Yūsuke, *Senzen no Ginkō•Shōken Seidō*, SHŌJI HŌMU No. 1048 (1960) 38; Tatsuta, SHŌKEN TORIHIKI HŌ I *supra* note 17, at 40. See also MAKOTO YAZAWA, *A Synopsis of Securities Regulation in Japan*, in JAPANESE SECURITIES REGULATION 26, 27 (Louis Loss et al. eds., 1983).

19. Public bonds formed the core of early exchange activity. The Meiji government issued large quantities of bonds to finance both government activity and the dismantling of the samurai class. The samurai received government bonds in lieu of their traditional allowance, but dire straits led many to sell, creating an active bond market. See Noda, *supra* note 17, at 50-55, 60; see also TATSUTA, *supra* note 17, at 41. Stocks were sources for speculation rather than investment. Early stock exchanges were for profit companies granted a local monopoly, and the stocks of the exchange companies themselves were speculatively traded. From 1928 to 1932, an average of 91.9% of the stock transactions were off-setting trades as used in futures transactions. Of the 91.9% of the futures type transactions, 50% was trading in the stock of the Tokyo Stock Exchange. Later railroad stocks became the focus of trading, and speculation in the stock of the seventeen private railroad companies occupied over half of all trading. Non-speculative trade in stocks, i.e. investment, was relegated to off-exchange trading. *Id.*

20. Milhaupt, *supra* note 14, at 428.

21. *Id.* at 429; see also TATSUTA, *supra* note 17, at 42.

curities market was to serve the war effort until it was closed following Japan's surrender.<sup>22</sup>

In 1948, Japan adopted the Securities Exchange Law, a law based on the United States Securities Act and Securities Exchange Act, and in 1949 the markets reopened for business.<sup>23</sup> For a brief period, the market was regulated by an independent securities exchange commission, a bureau external to the MOF and modeled after the Securities and Exchange Commission in the United States.<sup>24</sup> With the end of the occupation, the commission was abolished, and regulation of the securities market returned to the MOF whose mandate was twofold: regulate the securities industry and promote its growth.<sup>25</sup> The MOF, wearing two different and conflicting hats, proved most comfortable with administrative guidance rather than regulation, and promotion rather than prohibition.<sup>26</sup>

In 1991 and 1992, a series of loss compensation scandals were widely reported in Japan and later discussed in the academic literature in the United States.<sup>27</sup> It was discovered that

22. Milhaupt, *supra* note 14, at 430; *see also* TATSUTA, *supra* note 17, at 42-3.

23. Kunio Hamada & Keiji Matsumoto, *Securities Transaction Law in General*, in 5 *DOING BUSINESS IN JAPAN*, § 1.02[3] (Zentaro Kitagawa ed. 1999). The commodities market reopened in 1950 and was a precursor of things to come for the securities markets during the Bubble. The commodities market was beset by scandals precipitated by speculation and abusive sales practices. In 1963, the chief priest of a Buddhist temple was arrested for embezzlement after mortgaging a statute of the Kannon (Goddess of Mercy) in order to pay off losses in the futures market. The newspapers were replete with accounts of the solicitation of unsuitable customers and their unwitting involvement in futures. It was said that "in the shadow of crime stands the commodities market" (*hanzai no kage ni shōhin sōba ari*). Throughout the 1960s and 1970s, the Ministry of International Trade and Industry and the Ministry of Agriculture, Forestry and Fisheries issued a series of advisories (*tsutatsu*), and the Diet enacted a series of laws in an attempt to stem the abuses. *See* Asai Iwane, *Sakimono Torihiki Higai no Jittai to Kyūsai*, HANREI TAIMUZU No. 701 (1989) 77, 78.

24. Shōken Torihiki Hō [Securities Exchange Law (SEL)], Law No. 5 of 1948, § 165. *See also* Tatsuta Misao, *Shōken Torihiki no Kisei Kikan*, JURISUTO No. 989 (1991) 36, 38.

25. The Japanese Securities Exchange Commission was abolished under the guise of administrative reorganization, despite calls for its continuation by some in the securities industry. With the return of authority to the MOF and in order to allow for both guidance and regulation, the original registration requirement in the SEL was amended to require the licensing of securities companies. *See* TATSUTA, *supra* note 24, at 38; *see also* Zadankai, *Beikoku SEC to Shōken Torihikitō Kanshi linkai no Sōi (Jō)*, JUNKAN SHŌJI HOMU No. 1299 (1992) 2, 26.

26. ZADANKAI, *supra* note 25, at 7; Morita Akira, *Kanshi Kikan no Arikata—SEC•SIB wo Sankō ni Shite*, JURISUTO No. 989 (1991) 40, 43. *See also* Milhaupt, *supra* note 14, at 454.

27. *See, e.g.*, Jeffrey Char, *Reforming Japan's Securities Market – The Loss Compensation Scandal*, 10 INT'L TAX & BUS. L. 173 (1993); Masahisa Ikeda, *The Legality of Compensating Investors in the Japanese Securities Market*, 33 HARV. INT'L L. J. 592 (1992); Mitsuru Misawa, *Lost Compensation in the Japanese Securities*

securities companies were absorbing the losses of major clients, including politicians, institutional customers such as Hitachi and Toyota, and organized crime.<sup>28</sup> Public confidence in the fairness of the markets and the ability or willingness of the MOF to regulate it was shaken, and in 1992, the SESC was created.<sup>29</sup> The SESC was established as an external bureau of the MOF, similar to the National Tax Administration Agency.<sup>30</sup> Its stated goals were to “assure the fairness of transactions and maintain the trust of the investor in the markets.”<sup>31</sup> Responsibility for planning and legislation relating to the securities markets continued to rest with the MOF, with authority for the inspection of securities companies, the surveillance of the markets, and the investigation of criminal activity transferred to the SESC.<sup>32</sup> In 1998, with the creation of the Financial Supervisory Agency, the SESC became an external bureau attached to the Financial Supervisory Agency.<sup>33</sup> More recently, in July 2000 with the continued restructuring of the agencies regulating the financial markets, the SESC was transferred to the newly established Financial Services Agency, which also assumed control over securities related planning and legislation from the MOF.<sup>34</sup> Finally, in January 2001, as part of general government restructuring, the Financial Services Agency became an external bureau to the newly created Cabinet Office.<sup>35</sup>

Despite continued shuffling, the SESC’s mandate and authority has remained unchanged since its inception. It is charged with three tasks. First, under a grant of authority from the Finan-

*Market – Causes, and Search for a Remedy*, 25 VAND. J. TRANSNAT’L L. 37 (1992); Milhaupt, *supra* note 14, at 454.

28. Morita, *supra* note 26, at 41, 46; Sakano Tsunekazu, *Shōken Gyōkai he no Kata Furi Gyōsei ha Owari Subeki da—Beikoku Gaia SEC yori Ookurashō no Kansa Taisei Kyōka De*, ECONOMISUTO, July 30, 1991, at 12; *Sonshitsu Hoten Mondai kara Nani wo Manabu ka*, KINYŪ ZAISEI JIJŌ, Sept. 1991, at 26. In September 1991, an advisory committee issued a report attributing the recent scandals to three factors: (1) an emphasis in securities regulation on protection and development of the industry and a lack of competition in the markets, (2) a lack of clarity in the rules to be applied to the transactions, and (3) the inadequate role played by self-regulatory organizations. See Takano Shūichi, *Gyōkakushin ‘Shōken•Kinyū no Fukōsei Torihiki no Kihonteki Zeseisaku ni Kansuru Tōshin’ ni tsuite*, JURISUTO No. 989 (1991) 46-47.

29. SESC, 1993 ANNUAL REPORT 1, 2; Morita, *supra* note 26, at 41.

30. See generally Milhaupt, *supra* note 14, at 469-71 for an account in English of the original organization of the SESC.

31. SESC, 1993 ANNUAL REPORT 1.

32. *Id.* at 1, 2.

33. SESC, 1998 ANNUAL REPORT 113-14.

34. See SESC, 2000 ANNUAL REPORT 1. The Financial Services Agency is the result of the merger of the Financial Supervisory Agency and the Financial System Planning Bureau of the Ministry of Finance. *Id.*

35. *Id.*; see also Akira Ikeya, *Government Restructuring Pits Bureaucrats vs. Politicos*, THE NIKKEI WEEKLY, Dec. 4, 2000, at 1, 3.

cial Reconstruction Commission and the Financial Services Agency, the SESC is to inspect securities companies, those financial institutions with permission to engage in securities transactions, and self-regulatory organizations for compliance with regulations necessary to ensure the fairness of the transactions.<sup>36</sup> Second, with a similar grant of authority, the SESC is to oversee the daily operation of the securities markets.<sup>37</sup> Finally, based on a direct legislative grant of authority, the SESC is to investigate criminal acts that interfere with the fair operation of the securities market.<sup>38</sup>

The Commission itself is divided into two sections. The General Inspection Section conducts regular inspections of securities companies and financial institutions that engage in securities transactions, and it examines problematic transactions in the market. The Special Investigation Section investigates criminal acts involving securities.<sup>39</sup> Inspectors from Regional Financial Bureaus located throughout Japan assist both sections.<sup>40</sup>

The SESC is designed to be a policing agency in the strictest sense. Unlike the Securities and Exchange Commission in the United States, the SESC is to investigate, but has no authority to impose sanctions of any kind on those it investigates.<sup>41</sup> In the course of its routine inspections or criminal investigations, if the SESC finds evidence of wrongdoing, it has the legislative author-

36. As a bureau attached to the Ministry of Finance, the initial grant of authority came from the Minister of Finance. Authority later resided with the Prime Minister's Office, and now lies with the Financial Reconstruction Commission and the Financial Services Agency. See SESC, 1993 ANNUAL REPORT 4-5, 26; SESC, 1998 ANNUAL REPORT 33, 40, 73; SESC, 2000 ANNUAL REPORT 3(1).

37. SESC, 2000 ANNUAL REPORT 6(1).

38. *Id.* at 2(1). The SESC also has jurisdiction and regulatory responsibility for the financial futures markets. SESC, 1993 ANNUAL REPORT 22.

39. *Id.* at 3.

40. In 1999, the SESC was staffed with 112 people working with another 138 from the Regional Finance Bureaus. Regional Finance Bureaus are part of the Ministry of Finance and found in Tokyo, Osaka, Sapporo, Sendai, Nagoya, Kanazawa, Hiroshima, Takamatsu, Kumamoto, Fukuoka, and Naha. See SESC, 2000 ANNUAL REPORT 1(1-2); SHOKENTORIHAKI KANSHI IINKAI, SANKO SHIRYO 2 (Aug. 26, 1999) (on file with author).

41. The SEC in this regard provides an interesting point of comparison. The SEC was established as a "quasi-judicial" regulatory agency with broad power to sanction: an ability to pursue civil injunctive actions, administrative proceedings, contempt proceedings, civil penalties, disgorgement, and criminal indictments. See generally SEC, 1999 ANNUAL REPORT, available at <http://www.sec.gov/asec/annrep99/annrep99.htm> (last visited Jan. 31, 2001); Matthew S. Morris, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: By Keeping up with the Joneses, the SEC's Enforcement Is Modernized*, 7 ADMIN. L. J. 151, 155-60 (1993). There is a corresponding difference in the size of the institutions, with the SESC in Japan having approximately 250 on staff, compared to roughly 3200 at the SEC in the U.S. See Ryu Osumi & Takeshi Ando, *Securities Agencies Vow to Cooperate*, THE NIKKEI WEEKLY, Dec. 18, 2000, at 14.

ity to do one of three things.<sup>42</sup> First, it can issue a recommendation (*kankoku*) to the Financial Reconstruction Agency or the Financial Services Agency that an administrative sanction or other measure be taken vis-à-vis the SRO, financial institution, or securities institution inspected.<sup>43</sup> Second, if it finds evidence sufficient to sustain a criminal charge, it can issue an accusation (*kokuhatu*) and refer the matter to the procuracy, or prosecutor's office.<sup>44</sup> Third, if certain legislative or policy measures are deemed necessary, it may issue a proposal (*kengi*) that advises the Financial Reconstruction Commission, the Commissioner of the Financial Services Agency or the Minister of Finance of the need for administrative action.<sup>45</sup> Informally, the Commission can also simply point out the problem to the regulated entity or

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42. See SESC, 1998 ANNUAL REPORT 37. In the course of its inspections, the General Inspection Section has the power to make on-site inspections, review the books, and demand production of documents. Only the Special Investigation Section, which is limited to investigation of criminal wrongdoing, has the power to summon witnesses, obtain warrants, and conduct forced investigations. *Id.*

43. SESC, 1993 ANNUAL REPORT 31. Recommendations can be issued for a violation by a securities company of a statute, ordinance or other regulation, or where an SRO has failed to function or has been negligent in taking "necessary measures." When a securities company has violated the law, and an SRO has failed to administer the requisite sanction, such administration can also be requested. *Id.*

44. *Id.* at 6; see also SESC, 1994 ANNUAL REPORT 5.

45. Proposals, or *kengi*, for administrative action or new regulation are made by the SESC after an analysis of its inspections and investigations. *Kengi* should "in a case such as where there are inadequacies in existing regulations or SRO rules, point out that fact and . . . propose subjects for examination and reconsideration." SESC, 1994 ANNUAL REPORT 70. From 1992 to 2000, four proposals were made, three based on criminal investigations and one based on a general inspection. In a June 14, 1994 proposal sent to the Ministry of Finance, the SESC found in a criminal investigation of false representations in securities reports, inadequacies in the registration examinations of over-the-counter securities and proposed "necessary and appropriate measures be taken." The head of the Securities Bureau of the Ministry of Finance then instructed the Japan Securities Dealer Association (JSDA) to conduct an examination and "implement necessary and appropriate measures." The JSDA through a series of rule changes, policy changes, and notices (*tsūchi*) amended examination procedures. See SESC, 1994 ANNUAL REPORT 64-8. Following the same process, the SESC found problems in securities companies' internal supervision with regard to loss compensation. On December 24, 1997, they proposed to the Minister of Finance that necessary and appropriate measures be taken in order to systematize the separation of orders placed by securities companies for their own account and orders placed as agents. See SESC, 1998 ANNUAL REPORT 175. More recently, based on a 1999 SESC investigation of the Japan Long Term Credit Bank and discovery of misrepresentation in its filings, the Ministry of Finance amended its guidelines on disclosure of secured assets. In 2000, based on SESC findings of inappropriate business practices in the sale of investment trusts and foreign currency denominated products, the Financial Supervisory Agency notified Regional Finance Bureaus and issued a notice to the JSDA to instruct members so as to prevent inappropriate solicitation of investment. See SESC, 2000 ANNUAL REPORT, app. 2-4.

advise the relevant administrative agency of the problems uncovered and suggest remedial guidance without sanctions.<sup>46</sup>

The Financial Reconstruction Commission and Financial Services Agency, to which the SESC makes its recommendations, are bound by law to "respect" (*sonchō*) the recommendations of the SESC, and the SESC may request an accounting of actions taken regarding the recommendations made.<sup>47</sup> Nonetheless, after receiving SESC recommendations, the Financial Reconstruction Commission and the Financial Services Agency typically conduct independent hearings with the parties involved and retain final authority to determine what sanctions, if any, should be imposed.<sup>48</sup> Actual implementation of sanctions that relate to broker or dealer registration, such as the suspension and revocation of licenses, is entrusted to the Japan Securities Dealers Association (hereinafter JSDA). The JSDA, after receiving the results of an investigation, then conducts its own independent hearings and imposes the sanction.<sup>49</sup>

## 2. *SESC Accusations and Recommendations*

The SESC, and in turn the governmental agencies that are responsible for implementing SESC recommendations, have proven to be selective in their enforcement activities. There are few accusations and recommendations made, and of those made, most are aimed at loss compensation, insider trading or prohibited discretionary trading. Sections of the SEL addressing fraud have been the subject of scant, or in some cases no enforcement.

Looking first at accusations, the Special Investigation Section of the SESC from 1992 to 2000 referred thirty-one cases to the Procuracy, averaging less than four a year.<sup>50</sup> Of those, eleven involved insider trading, seven involved loss compensation or provision of special profits and the remainder consisted of an assortment of violations including market manipulation, dissemination of rumors with intent to influence the market, and misrepresentation in documents filed with the Ministry of Finance (See Chart 1).<sup>51</sup>

The sale of Princeton Bonds by the Tokyo branch of Cresvale International, Ltd. brought two accusations in March of 2000 and the only instance of an accusation based on oral misrep-

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46. Interview with SESC official, in Tokyo, Japan (Sept. 2, 1999). See also SESC, 1998 ANNUAL REPORT 45.

47. SESC, 2000 ANNUAL REPORT 4(1).

48. *Id.*

49. SESC, 1998 ANNUAL REPORT 63.

50. SESC, 2000 ANNUAL REPORT, app. 2-1.

51. *Id.*

CHART 1  
ACCUSATIONS ISSUED BY THE SESC: 1992 TO 2000

Violations	Cases	Companies	Individuals
Market manipulation	3	1	6
Failure to file a large holdings report	0*	0	1
Submission of securities report falsely representing material facts	6	4	18
Insider trading	11	6	45
Distribution of rumors with the purpose of altering securities markets	2	0	2
Unlawful provision of property gains to customers	7	7	38
Unlawful demand and receipt of property gains by a customer	0*	0	1
Use of a deceptive scheme in the sale of a security	2	2	3
Total	31	20	114

\*Accusation based on multiple counts including the instant violation

\*\*SESC, 1998 Annual Report 137-141; SESC, 1999 Annual Report, Ch. 2; SESC, 2000 Annual Report, Ch. 2.

resentations in the sale of securities.<sup>52</sup> SEL Section 158 prohibits unfair practices, the objective of which is to effectuate a change in the market. In the offer, purchase or sale of a security, “no person . . . shall with the objective of changing a market disseminate rumors, employ a deceptive practice, or engage in an act of violence or threat.”<sup>53</sup> Cresvale Japan and its representative director were alleged to have “used a deceptive scheme in the sale of a security by falsely explaining among other things, that ‘with Princeton Bonds the safety of the customer’s assets is the number one investment philosophy’” notwithstanding knowledge of ac-

52. Cresvale International Ltd. was a division of the Princeton Group whose chairman, Martin Armstrong, was indicted for securities fraud in the U.S. Seventy-six Japanese companies purchased from Cresvale International 113.8 billion yen worth of Princeton bonds, which later became worthless. The scandal however was not limited to the conduct of Mr. Armstrong. Investigation revealed a host of wrongs: broker misrepresentation in the sale of the bonds, tax evasion by both Cresvale officials selling the bonds and officials of companies buying them, kick-backs paid by Cresvale to company officials for their purchases, and use of the bonds by the companies to conceal losses. See Tsutomu Nanbara & Yoichiro Osawa, *Princeton Bond Buyers Weigh Next Move*, THE DAILY YOMIURI, Oct. 11, 1999, at 2. See also *Cresvale Head Quizzed on Fraud*, THE JAPAN TIMES, Oct. 6, 1999, at 2; *Ten Companies Used Princeton Bonds to Cover up Losses*, THE DAILY YOMIURI, Dec. 7, 1999, at 3; *Former executive of Yakult, Cresvale arrested in tax probe*, THE NIKKEI WEEKLY, Dec. 6, 1999, at 12; *Yakult Exec Faces More Charges*, ASAHI SHIMBUN, Dec. 29, 1999, at 1.

53. SEL § 158.

counting irregularities and of the risk that the bonds would not be redeemed.<sup>54</sup>

The General Inspection Section in its inspections has focused on loss compensation, solicitation with guarantees of profits or guarantees against losses, and prohibited discretionary trading. From 1992 to 2000, out of a total of fifty-seven firms and 315 individuals sanctioned, twenty-four firms and 112 individuals were sanctioned for violations of regulations prohibiting loss compensation or provision of special profits.<sup>55</sup> An additional nine firms and 113 individuals from that total were sanctioned for discretionary trading.<sup>56</sup> In other words, roughly two-thirds of SESC regulatory activity has focused on loss compensation and discretionary trading.

For the remaining one-third, SESC summaries reveal an assortment of acts for which brokers and securities companies have been sanctioned (See Chart 2). Largely missing are the kind of cases that have occupied the Securities and Exchange Commission in the United States and the Japanese judiciary since the Bubble burst, i.e. securities companies providing "conclusive evaluations" or guarantees of a rise or fall in the price of an investment product, recommending unsuitable investments, or failing to explain the structure and risks of the investment vehicle.<sup>57</sup>

The SESC's limited attempt to address garden-variety fraud issues begins with SEL Section 42, which enumerates specifically

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54. SESC, 2000 ANNUAL REPORT 2(2). The SESC and the procuracy's use of Section 158 instead of Section 157 is unexplained. Section 157 is a more general anti-fraud provision patterned on Section 10(B) of the U.S. 1934 Securities Exchange Act (15 U.S.C. 78j(b)), and unlike Section 158 requires no intent to influence the market. No person shall "in the purchase or sale of a security or other transaction . . . employ any fraudulent device, scheme, or artifice" or "make false representations regarding material facts or omit material facts in documents or other representations necessary to prevent misunderstanding for the purpose of obtaining money or other property," or "for the purpose of inducing the purchase or sale of a security or other transaction . . . use a false market." See SEL § 157 (1-3); HATTORI IKUO, SHIN SHOKEN TORIHIKI HO KOGI 199-120 (1998) (noting section 157 has been invoked rarely, and been interpreted as dead-letter). The violation of either Section 157 or Section 158 carries up to five years imprisonment and up to a five million yen fine; corporation violations are subject to fines up to 500 million yen. See SEL § 197(5) and 207(1)(1).

55. SESC, 2000 ANNUAL REPORT, app. 2-3.

56. *Id.* Discretionary trading is a common vehicle for funneling profits or compensation to favored customers, and, with limited exceptions, prohibited under SEL Section 42(1). See KAWAMOTO ICHIRŌ & ŌTAKE YASUNAMI, SHŌKEN TORIHIKI HŌ DOKUHON [DAI 4 HAN] 119, 120 (2000); Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW.U.L.REV. 1436, 1493 (1994). An example of permitted discretionary trading includes purchase orders to be placed on foreign exchanges where time differences may necessitate giving limited discretion such as providing a price range within which the order may be executed. See Hattori, *supra* note 54, at 45; Kawamoto & ŌTAKE, *supra* at 119-20.

57. See Part II *infra*.

CHART 2  
1992 – 2000 RECOMMENDATIONS ISSUED BY THE SESC

Violations and Recommendations	Companies	Persons
Bucketing	9	17
Failure to provide, or provision of falsified transaction reports	6	7
Provision of a “conclusive evaluation” about a prospective rise or fall in stock or market price	0	2
Formation of contracts providing for discretionary trading	9	113
False statements made concerning securities transactions, or actions which cause misunderstanding regarding material facts	1	9
Solicitation through the guarantee of special profits	8	22
Engaging in a series of securities transactions which “create an artificial market”	6	8
Acceptance of a series of securities transaction orders with knowledge of their manipulative effect on the market	10	25
Securities transactions made for speculative profit by directors and employees of securities companies	0	47
Insufficient supervision of the buying and selling of securities from the standpoint of prevention of unfair transactions involving corporate information	1	0
Visitation of customers with employees of a parent bank	1	1
Transactions with a parent company on conspicuously different terms than normal transactions	2	0
Receipt of non-public information about an issuer of securities from a parent company	0	1
Provision of credit by the underwriter when selling a security	1	1
Conspicuously inappropriate acts by registered representatives in the course of their employment	0	9
Use of deceptive schemes in soliciting securities transactions	1	1
Short selling in violation of government ordinance	7	0
Insider trading by corporate employees	0	2
Purchase of securities for one’s own account during a stabilization period	1	0
Agreement to provide property gains to compensate for losses incurred	0	1
Provision of property gains to compensate for losses incurred	13	69
Solicitation of securities and other transactions through guarantees to cover losses arising from the transaction	3	20
Filing securities reports containing false representations of material matters	1	3
Filing a false report in response to a demand for an accounting	1	2
Total Violations	81	360
Total Recommendations Issued*	57	315

\*Includes individuals and corporations charged with more than one violation of the law or regulations.

\*\*Chart based on SESC 2000 Annual Report, app. 2-3.

prohibited conduct including “acts of solicitation by providing conclusive evaluations (*dantei teki na handan*) that the price of a security or an option will rise or fall.”<sup>58</sup> From 1992 to 2000, the SESC found a registered representative of a securities company at fault for offering conclusive evaluations regarding the movement of stock prices only twice.<sup>59</sup> In 1996, the SESC found a customer had proposed suspending trading after sustaining mounting losses through margin transactions, and the broker in response solicited further purchases by stating that the price of stocks over a two-month period would “absolutely rise.”<sup>60</sup> The SESC recommended sanctions, and a two-week suspension for the broker was imposed.<sup>61</sup> A similar recommendation was issued during the 1999 inspection year where a broker offered a conclusive evaluation that the price of a specific stock would rise.<sup>62</sup>

Apart from conclusive evaluations, there have also been a small number of recommendations resulting from false representations or representations causing misunderstanding about material facts. SEL Section 42 prohibits acts enumerated in accompanying regulations such as the “Order Regarding the Regulation of Acts of Securities Companies.” Section 4(1) of this Order prohibits “false representations or representations which cause misunderstanding of material facts” in the purchase or sale of securities.<sup>63</sup> The first recommendation based on this provision was made on June 7, 1994, against the section chief of a securities company who created false account statements to conceal the poor performance of earlier transactions and falsely represented the price of securities.<sup>64</sup>

More recently, the SESC invoked Section 4(1) as part of an October 2000 recommendation issued against Cresvale International employees where written materials (balance statements, summaries and other solicitation materials) containing “false representations” were disseminated.<sup>65</sup> The prohibition against state-

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58. SEL § 42(1)(1). Sections 42 (1) (2)-(4) proscribe the same conduct in the solicitation of swap and futures transactions. Violation of this provision can result in the loss of license, a six-month suspension, or removal of management. See SHŌKEN TORIHIKITO KENKYŪKAI HEN, SHŌKEN TORIHIKITO KANSHI INNKAİ NO KATSUDŌ JŌKYO—HEISEI 9, app. 309 (Kinyū Zaisei Jijō Kenkyūkai ed., 1998).

59. SESC, 1998 ANNUAL REPORT 171-72.

60. SESC, 1997 ANNUAL REPORT 160.

61. *Id.*

62. SESC, 1999 ANNUAL REPORT 4(2).

63. SEL § 42(1)(9); SHŌKEN KAISHA NO KOI KISEI NI KAN SURU MEIREI [ORDER REGARDING THE REGULATION OF ACTS OF SECURITIES COMPANIES] § 4(1) as amended 1998.

64. SESC, 1997 ANNUAL REPORT 151. A recommendation based on a similar fact pattern was also issued in 1999. See SESC, 1999 ANNUAL REPORT 4(2).

65. SESC, 2000 ANNUAL REPORT 4(2). See also SESC, 1997 ANNUAL REPORT 162, 165 (showing other examples, including an October 1996 recommendation

ments that “cause misunderstanding of material facts” has also been invoked, but only once. It occurred in a June 2000 recommendation against a Merrill Lynch broker who intentionally employed a standard different from that used previously in order to provide a customer with a higher valuation of their bond holdings and encourage further purchases.<sup>66</sup> While these provisions are inclusive of oral representations, their application has been limited to instances where there was an accompanying written falsehood.

SEL Section 42 also prohibits “excessive solicitation,” solicitation of the purchase or sale of a specific stock from unspecified and numerous customers for a continuous period of time,<sup>67</sup> and Section 170 further prohibits the solicitation of multiple customers through the offer of special terms or conditions.<sup>68</sup> There have not been, however, any administrative sanctions involving either provision.<sup>69</sup> “Conspicuously inappropriate” acts by registered representatives have been sanctioned, but interpretation of this category of activity has been limited to instances of recommendation of, or assistance in, concealing the identity of the investor.<sup>70</sup>

SEL Section 43 addresses suitability issues by providing that securities companies “must conduct business so as not to” solicit securities transactions, securities futures transactions, options transactions, or the commission of such transactions “where it is recognized to be inappropriate in light of the customer’s knowledge, experience, and financial circumstances, and would result in a lack of investor protection or present such a risk.”<sup>71</sup> This provision, while not formulated as a strict prohibition, makes explicit a suitability rule, the violation of which subjects the securities company to administrative sanctions under Section 56.<sup>72</sup> The

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against an office manager of a securities company who disseminated false account statements and report certificates as he embezzled customer funds. In June 1997, a registered representative was sanctioned for failing to confirm the market price and in doing so making false representations about the price while mediating the sale of securities between two customers.)

66. See SESC, 2000 ANNUAL REPORT 4(2) (A March 15, 1998 recommendation was also issued for misleading solicitation materials used in the sale of bonds but was based this time on SEL § 158.)

67. SEL § 42 (1) (7).

68. SEL § 170.

69. SESC, 2000 ANNUAL REPORT, app. 2-3; SESC, 1998 ANNUAL REPORT 171-72.

70. SESC, 1997 ANNUAL REPORT 147.

71. SEL § 43 (1).

72. SESC, 2000 ANNUAL REPORT, app. 1-5; Interview with SESC official, in Tokyo, Japan (Sept. 2, 1999). There has long been an emphasis in the black letter law on suitability. Prior to the 1998 revision of the SEL, Section 54 (1) provided that in the case of “solicitation where it is recognized to be inappropriate in light of the customer’s knowledge, experience, and financial circumstances, and would result in a lack of investor protection or present such a risk” the prime minister “when recog-

SESC has never recommended a sanction against a securities company or broker for violation of the suitability section.<sup>73</sup>

While there is no explicit provision setting out a “duty to explain,”<sup>74</sup> there are sections of the SEL that mandate disclosure. Section 38 requires securities companies to disclose to the customer, upon receipt of an order, whether it will act as a principle, an agent or a proxy in the transaction when filling the order.<sup>75</sup> There have been no sanctions under this section.<sup>76</sup>

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nizing it necessary and appropriate for the protection of the investor and the public interest, can order changes in business practices, a total or partial suspension of business for a designated period up to three months, or other measures necessary as a matter of supervision.” Prior to 1998, the Ministerial Ordinance Concerning Rules for the Soundness of Securities Companies also contained a suitability rule. Section 8(5) provided for corrective measures where securities futures or options transactions were undertaken “when there is solicitation recognized to be inappropriate in light of the customer’s knowledge, experience, or financial assets and lacking in investor protection or presenting such a risk.”

Earlier Ministry of Finance administrative guidance also stressed suitability. The December 2, 1974, Ministry of Finance Circular No. 224 titled “About Complete Investor Centered Business Practices” and directed to the head of the Japan Securities Dealers Association noted that excessive solicitation that neglected the interests of investors in an attempt to raise profits resulted in loss of investor confidence. The circular instructed, “[w]hen soliciting investment from investors, the securities company must adequately consider the investor’s interests, investment experience, financial strength and the like so that the most suitable investment will be made. In particular, it is expected that solicitation of investment from investors with meager resources or investors with insufficient knowledge and experience investing in securities will be conducted with greater care.” Moreover, “securities companies will only conduct transactions with investors that meet the respective minimum standards.” A later November 1, 1983, Ministry of Finance Circular No. 1404, to the Japan Securities Dealers Association focused specifically on over-the-counter securities transactions and contained a similar instruction that “care be taken so that the most suitable investment be made.” As with the ministerial ordinance, these circulars were repealed, replaced by the general suitability provision in the SEL. See *Shōken Torihiki Hou Kenkyūkai, Heisei 4 no Shōken Torihiki Hō No Kaisei (12) – Shōkengyō Kyōkai (1)*, *INBESUTOMENTO* (1994) 77, 78; *Shōken Torihiki Hō Kenkyūkai, Heisei 4 No Shōken Torihiki Hō No Kaisei (14) – Shōkengyō Kyōkai (3)*, *INBESUTOMENTO* (1994) 30.

73. SESC, 1998 ANNUAL REPORT 171-72.

74. See *infra* Part II regarding judicial formulation of the duty to explain. The SEL contains only Section 33, which provides that “securities companies, their officers, and employees must vis-à-vis the customer perform their work in good faith and fairness.” This general “good faith” section has been interpreted as providing a basis for the duty to explain. Kamiyanagi Toshio, *Tekigōsei Gensoku to Setsumei Gimu wo Meguru Hanrei Hōri to Kadai*, *KINYŌ HOMU JIJŌ* No. 1535 (1999) 27, 29. In comparison, Section 33 provides a far more indirect basis for a duty to explain than the direct support the circulars, ordinances, and SEL provisions provide for a suitability rule.

75. SEL § 38. Violation of this provision can result in the loss of one’s license, a six-month suspension, or removal of management. See *SHŌKEN TORIHIKITO KENKYŪKAI HEN, SHŌKEN TORIHIKI TŌ KANSHII INNKAİ NO KATSUDŌ JOKYŌ—HEISEI 9, supra* note 58, at 307.

76. SESC, 2000 ANNUAL REPORT, app. 2-3; SESC, 1998 ANNUAL REPORT 171-72.

Section 40 requires that explanatory materials be provided to customers engaging in high-risk transactions such as stock futures, options, and derivatives transactions. The securities companies “must provide written materials stating the nature of the transaction and other items prescribed by ordinance of the Prime Minister’s Office or the Ministry of Finance” to customers in advance of the transaction.<sup>77</sup> There have been no sanctions for failure to provide this explanatory material.<sup>78</sup>

In short, there have been very few sanctions for “conclusive evaluations” of prospective changes in the markets and for written misrepresentations. There have been no sanctions for unsuitable recommendations or failure to warn of risk.

### 3. *Inspections and Problems “Recognized”*

The disproportionate number of sanctions for insider trading and loss compensation, in comparison to the few misleading representation cases and the total absence of suitability or disclosure of information cases, is not an indication that the SESC has found few problems in the retail sector. It has consistently “recognized” (*mitomeru*) such problems in its scheduled inspections of the securities companies and noted them in its Annual Report.<sup>79</sup>

The SESC has emphasized three areas in their inspections of securities companies: “compliance with transaction rules,” “business practices,” and “internal supervisory systems.”<sup>80</sup> Only violations of transaction rules, and among those only “significant

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77. SEL § 40. Violation of this requirement can result in up to six months imprisonment and up to a ¥500,000 fine. See SHŌKEN TORIHIKI TO KENKYŪKAI HEN, SHŌKEN TORIHIKI TO KANSHI INNKAİ NO KATSUDO JŌKYŌ—HEISEI 9, *supra* note 58, at 307.

78. SESC, 2000 ANNUAL REPORT app. 2-3; SESC, 1998 ANNUAL REPORT 171-172.

79. The SESC has also documented complaints received from investors, and these complaints show a different set of priorities from those evidenced by SESC recommendations. From 1995 to 2000, there were twenty-six complaints relating to discretionary trading as opposed to 109 regarding unauthorized trading, fifty-four regarding solicitation based on conclusive evaluations, and forty-nine relating to unsuitable recommendations. See SESC, 1998 ANNUAL REPORT 80; SESC, 2000 ANNUAL REPORT 7(2). The largest number of investor inquiries related to unauthorized trading, for which there are no related SESC recommendations or sanctions. There were numerous complaints about conclusive evaluations and unsuitable recommendations, but only the two SESC recommendations for conclusive evaluations discussed earlier were issued. Investor inquiries relating to discretionary trading were few in number, while SESC recommendations for discretionary trading were second only to loss compensation recommendations.

80. SESC, 1993 ANNUAL REPORT 16; SESC, 1994 ANNUAL REPORT 2; SESC, 1995 ANNUAL REPORT 2; SESC, 1996 ANNUAL REPORT 2; SESC, 1997 ANNUAL REPORT 2; SESC, 1998 ANNUAL REPORT 2.

violations," result in the issuance of the kind of recommendations previously discussed.<sup>81</sup>

Inspection of internal supervisory systems involves the oversight of securities companies' risk management systems, such as its requirements for trading options, warrants and other high-risk products, and its "attention systems" designed to flag accounts that are engaging in unusually heavy trading or sustaining heavy losses.

The SESC has consistently found securities companies that aggressively marketed investment products but did not include them in their attention systems.<sup>82</sup> In other cases, the attention systems flagged problem accounts, but the securities companies took little or no remedial action.<sup>83</sup> Failures and delays in obtaining the required written confirmation of understanding from customers trading in high-risk products, such as stock index options, have been a perennial problem.<sup>84</sup> The SESC has not, however, issued any related recommendations.

In the area of business practices, the SESC has consistently found "solicitation of investment which can be regarded as neglecting the intentions of the investor."<sup>85</sup> In doing so, the SESC has developed, or adopted from the courts, increasingly sophisticated legal principles, but has gone no further than to simply note the violation, and in some instances contact the relevant administrative agency and through this agency provide instruction to the securities company inspected.<sup>86</sup>

In 1994, the SESC found problematic business practices when Securities Company F<sup>87</sup> emphasized high returns and safety in the explanation and sale of investment trusts containing foreign stocks and derivatives,<sup>88</sup> and later redeemed shares during the investment trust's closed period for customers "who had received inappropriate explanations about the risk" after the

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81. Apart from "significant violations" and the resulting recommendations, less significant infractions are resolved through administrative guidance by the SESC contacting the relevant administrative agency, which then contacts the inspected company and issues instructions or recommendations. *See* SESC, 1998 ANNUAL REPORT 45.

82. *See* SESC, 1995 ANNUAL REPORT 35; SESC, 1997 ANNUAL REPORT 37-8.

83. *See* SESC, 1996 ANNUAL REPORT 55-6; SESC, 1997 ANNUAL REPORT 38; SESC, 1998 ANNUAL REPORT 57.

84. *See* SESC, 1995 ANNUAL REPORT 36; SESC, 1996 ANNUAL REPORT 55-6.

85. SESC, 1994 ANNUAL REPORT 2; SESC, 1995 ANNUAL REPORT 2; SESC, 1996 ANNUAL REPORT 2; SESC, 1997 ANNUAL REPORT 2; SESC, 1998 ANNUAL REPORT 2.

86. SESC, 1998 ANNUAL REPORT 45, 48-9; Interview with an SESC official, in Tokyo, Japan (Sept. 2, 1999).

87. The securities companies are not identified in the SESC Annual Reports, but denoted by letter.

88. SESC, 1994 ANNUAL REPORT 78-9.

trusts dropped in value.<sup>89</sup> In another case, the SESC found a securities company that sold investment trusts by emphasizing the safety of its principal and its high returns, as well as by making misleading statements about the risk of currency fluctuation. After a drop in the trust's value, this firm also redeemed shares during its closed period for customers "who had received inappropriate explanations regarding the risk of currency fluctuation."<sup>90</sup> In both of these cases, the SESC acknowledged violations of the broker's duty not to mislead and the duty to explain but issued no sanction.

In 1995, the SESC followed the same pattern, finding business practices that "neglected the intent of the investor."<sup>91</sup> Securities Company E was determined to have aggressively marketed foreign stocks, investment trusts, and convertible bonds.<sup>92</sup> Transaction records reflected repeated short-term buying and selling of the same products at a loss, and among those transactions multiple instances of "excessive solicitation that neglected the nature of the product and the intent of the investor."<sup>93</sup> In another inspection, the SESC looked at transaction records from multiple branches of a securities company that had aggressively marketed specific stocks, and on numerous occasions purchased and sold the same security on the same day with "disregard for the intent of the investor."<sup>94</sup> In essence, the SESC found churning but recommended no sanctions.

Inspections since 1995 have brought more of the same. In 1996, the SESC issued one recommendation for a broker offering conclusive evaluations about a stock's rise in price, but recognized four additional cases of "solicitation that disregarded the characteristics of the customer."<sup>95</sup> A representative example is Securities Company K, which recommended the purchase of yen-based foreign bonds to conservative investors and then bought and sold them at a loss in a series of short-term transactions.<sup>96</sup> The SESC found the transactions involved "solicitation of the purchase of similar products from customers who did not desire to make additional investments, had insufficient investment knowledge and experience, and had received an inadequate explanation of the nature of the product."<sup>97</sup> The SESC noted that,

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89. *Id.*

90. *Id.*

91. SESC, 1995 ANNUAL REPORT 34

92. *Id.*

93. *Id.*

94. *Id.*

95. SESC, 1996 ANNUAL REPORT 52-4.

96. *Id.* at 53.

97. *Id.* at 52-53.

in addition to the churning of customers' accounts, there were suitability problems and an inadequate explanation of the investment vehicles but issued no sanction.<sup>98</sup>

Later inspections continued to find "solicitation that neglected the interests of the customer."<sup>99</sup> In 1997, Securities Company R was determined to have aggressively marketed investment trusts and convertible bonds, and in the course of this "solicited the trading of same currency foreign bonds without an adequate explanation of costs related to currency exchange when trading."<sup>100</sup> The SESC found unnecessary costs were incurred and held this to be "a case where the trading lacked reasonableness for the customer."<sup>101</sup> In conjunction with other abusive practices, the SESC observed that,

[A]gainst a background of business practices in which there was insufficient understanding of the nature of the products and a strong culture of prioritizing commissions, this was a case where transactions were solicited which neglected the interests and investment intent of customers who had little knowledge of or experience with the product.<sup>102</sup>

Other investigations disclosed the same, trading solicited "without adequate explanation . . . incurring unnecessary currency exchange costs, and lacking in economic reasonableness."<sup>103</sup> In these inspections, the SESC added a general

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98. In 1996, the SESC also found Securities Company J recommended on numerous occasions that customers switch from investment trusts to convertible bonds and then proceeded to trade those bonds at a loss. The SESC found "these trades were, generally speaking, the result of aggressive solicitation of trading in pursuit of short-term profits which did not adequately take into consideration the customer's characteristics such as their financial resources and their basic investment purposes. In addition, the explanation of the nature of the product was not adequate." Securities Company L was determined to have "neglected the costs and the like associated with currency movements in recommending the trading of foreign currency denominated foreign bonds." In the case of Securities Company M, brokers were found to have aggressively marketed a pair of investment trusts: one designed for bull markets and one designed for bear markets. Both were sold with the advice that the customer could switch to the one that was generating profits. Thereafter, the trusts were repeatedly bought and sold at a loss. The SESC indicated this was the product of "insufficient consideration by the broker of the customer's knowledge and experience, insufficient explanation at the time of solicitation about the nature of both products and the investment technique of combining both, as well as the customer having an inadequate understanding of the same products." See SESC, 1996 ANNUAL REPORT 53-54.

99. SESC, 1997 ANNUAL REPORT 33.

100. *Id.*

101. *Id.* at 34.

102. *Id.*

103. SESC, 1997 ANNUAL REPORT 36. In the 1997 inspections, the SESC found Securities Company S had aggressively marketed convertible bonds and foreign bonds to investors with little knowledge or experience and mid to long term investment goals. The bonds were "solicited emphasizing the pursuit of short-term profits without adequate explanation of the nature of the product." Securities Company T

requirement of reasonableness, similar to the reasonable basis requirement found under the shingle theory in the United States, but as in other cases it made no efforts to sanction.<sup>104</sup>

The SESC has continued to find “solicitation of investment which neglected the interests of the customer,”<sup>105</sup> and the legal underpinnings of the SESC findings have evolved to include a duty not to mislead, not to solicit unsuitable transactions, a duty to explain and a “reasonableness” requirement for the transactions. It is, however, the corresponding lack of any administrative sanction for securities companies and brokers churning accounts and recommending unsuitable transactions that is remarkable. These activities are not deemed “significant rule violations” warranting issuance of a recommendation.<sup>106</sup> The SESC has only “recognized” problems in limited circumstances where there was a clear paper trail and recommended remedial action via other agencies.<sup>107</sup>

In the period from 1992 to 2000, the SESC has devoted its time and resources to loss compensation and discretionary trading. The SESC has “recognized” misrepresentation, churning, unsuitable recommendations, and failure to explain risk but has abdicated regulatory responsibility in this area.

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was likewise found to have pursued growth in the sales of foreign bonds and to have “solicited trading that emphasized the quick return of capital and increases in profits without adequate explanation of the currency exchange costs and the like” from conservative investors with little knowledge or experience in investing in foreign bonds. At Securities Company V, the home office set sales targets and selected stocks to be recommended. Each branch was then assigned a percentage based on those targets and solicited accordingly. The SESC found among customers’ accounts instances of short-term trading at a loss and repeated buying and selling of the same product. *See SESC, 1997 ANNUAL REPORT 35-6.*

104. In finding transactions “lacking reasonableness,” the SESC conducts an inquiry very similar to that conducted by the Securities and Exchange Commission in the U.S. Under the shingle theory in the U.S., there is a requirement of an “adequate basis” or “reasonable grounds” for the recommended transaction. *See Hanley v. SEC, 415 F.2d 589, 595-96 (2nd Cir. 1969)* (“A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinion he renders.”). *See also In re Phillips & Co., 37 SEC 66 (1956), 1956 SEC Lexis 160, at \*10* (“The record shows that [the broker] knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist”); *In re Alexander Reid & Co., 40 SEC 986 (1962), 1962 SEC Lexis 514, at \*10* (“Groundless opinions come within the ambit of false or misleading statements prohibited by securities law.”); *In re Foster, 1994 SEC Lexis 2107, at \*5* (Predictions made to customers that the prices of recommended stocks would rise to specified levels within specified time periods “without a reasonable basis” held actionable).

105. *SEC, 1998 ANNUAL REPORT 54; SESC, 1999 ANNUAL REPORT 3(4); SESC, 2000 Annual Report 3(4).*

106. *SEC, 1998 ANNUAL REPORT 45, 48-9.*

107. *SEC, 1998 ANNUAL REPORT 45; Interview with SESC official, in Tokyo, Japan (Sept. 2, 1999).*

## B. JAPAN SECURITIES DEALERS ASSOCIATION

### 1. *Its Origins, Organization, and Authority*

The self-regulatory organizations, including the Japan Securities Dealers Association (JSDA) have followed a very similar path, albeit walking three steps behind the SESC. They have sanctioned little, but “recognized” problems based on an inspection of member records and, in limited circumstances, provided remedial guidance.

The JSDA along with the Tokyo Stock Exchange and the Osaka Stock Exchange form the backbone of the self-regulatory organizations operating in Japan.<sup>108</sup> It is, however, the JSDA that bears primary responsibility for the regulation of securities companies and their brokers as well as the sale of investment trusts and other over-the-counter products.<sup>109</sup>

The JSDA has its origins in the Tokyo, Osaka and other regional securities dealers associations that were formed with the enactment of the United States inspired SEL in 1948. The regional associations were disbanded and replaced by the JSDA in 1973, when it was organized under the Civil Code and registered with the Ministry of Finance’s Association Registry.<sup>110</sup> In 1991, with the advent of the loss compensation scandals, the JSDA was reorganized as a corporate entity under the SEL in an attempt to clarify and emphasize its regulatory mandate.<sup>111</sup>

The JSDA currently operates as a member organization and regulatory body for approximately 550 securities companies and financial institutions operating in the securities industry.<sup>112</sup> It has a general congress, a board of directors and a general office. The general office is divided into numerous sections and offices, including the Audit (*kansa*) Section, the Special Members Audit

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108. See generally SESC, 1993-2000 ANNUAL REPORTS. The Niigata and Hiroshima stock exchanges closed in 2000 and the Kyoto stock exchange closed in 2001. See Yusho Cho, *NSE Embarks on Reform Path*, THE NIKKEI WEEKLY, Mar. 19, 2001, at 12. With the consolidation among the regional stock exchanges, the significance of their regulatory activities has likewise diminished.

109. See SESC, 1993 ANNUAL REPORT 53-54. Apart from the TSE and OSE, the JSDA also continues to oversee and operate in conjunction with the Financial Futures Dealers Association and the Tokyo Financial Futures Market. See SESC, 2000 ANNUAL REPORT 9(4) and (5).

110. Kawamoto Ichirō, *Jishu Kisei Kikan—Shōkengyō Kyōkai o Chūshin ni Shite*, HŌGAKU KYŌSHITSU No. 162 (1994) 60, 62; see also Wataru Horiguchi, *Regulation of Broker-Dealers*, in SECURITIES REGULATION IN JAPAN 81, 83 (1983).

111. See SEL §§ 67-79 inclusive.

112. In 1998, the JSDA had 348 on staff, including approximately forty inspectors; it regulated 547 member firms. Interview with JSDA official, in Tokyo, Japan (Sept. 3, 1999); see also NIHON SHOKENGYO KYOKAI PANFURETTO (Sept. 1, 1998) (on file with the author).

Section, and the Grievance Resolution Supervision Office.<sup>113</sup> In addition, there are a variety of commissions operating both internally, such as the Discipline Commission, and externally, such as the affiliated Mediation Commission.<sup>114</sup>

Its objectives are “to ensure that . . . securities transactions conducted by members are fair and smooth (*enkatsu*), to promote the sound development of the securities industry, and to contribute to the protection of investors.”<sup>115</sup> It engages in two distinct regulatory functions.<sup>116</sup> First, based on a grant of authority from the Financial Reconstruction Commission, it is responsible for carrying out administrative sanctions imposed by an administrative agency, such as the SESC, on a member institution or registered representative.<sup>117</sup> Second, under Articles 25 and 26 of the JSDA’s Articles of Incorporation, it is responsible for conducting independent inspections of member companies’ compliance with relevant laws and ordinances, rules, and good faith requirements, and issuing sanctions when necessary.<sup>118</sup> On discovery of a violation, and after providing an opportunity to be heard, the JSDA may issue a recommendation (*kankoku*), reprimand (*kenseki*), assess fines, suspend membership or expel the offending member.<sup>119</sup>

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113. *Id.*

114. *Id.* See also *TSE Set to Become Joint-stock Company*, THE NIKKEI WEEKLY, Mar. 5, 2001, at 12 (In February 2001, the JSDA spun off the over-the-counter market it had administered as JSDAQ, Inc., a publicly traded joint-stock company. The Osaka and Tokyo Stock Exchanges reorganized as publicly traded companies in April and October of the same year.)

115. JSDA Articles of Association § 5 (1); SEL § 67 (1).

116. The general duties of the JSDA are enumerated as follows: 1) the enactment and enforcement of SRO rules; 2) the investigation of members’ observance of laws and ordinances, administration of sanctions based on laws and ordinances, articles of association and rules, or principles of good faith in transactions; 3) the supervision of over-the-counter markets in stocks, bonds, and the like; 4) the offering of consultation services for stock transaction related grievances; 5) the education and training of securities companies employees and the administration of the certification examinations; and 6) the management of matters related to the registration of representatives employed with member companies. See SESC, 1993 ANNUAL REPORT 53-54.

117. SEL § 64-7(1); SESC, 2000 ANNUAL REPORT 4.

118. NIHON SHÖKENGYO KYÖKAI, TEIKAN•KISOKU [JSDA, ARTICLES OF ASSOCIATION AND RULES] 7 (1999); SESC, 1993 ANNUAL REPORT 58. SEL Section 79-7 provides authority for Articles 25 and 26 inspections and sanctions. With governmental authority to sanction limited to violation of statute or ordinance, the authority of the JSDA to regulate and sanction based on its rules of conduct (*kōkanki*) and good faith requirements is far greater in scope, but as will be discussed *infra*, this greater authority has not been exercised.

119. SESC, 1993 ANNUAL REPORT 58; Interview with JSDA officials, in Tokyo, Japan (Sept. 3, 1999). In contrast to the Securities and Exchange Commission in the U.S., the SESC does not act as an appeals body for sanctions imposed by an SRO. JSDA sanctions once imposed are final.

Unlike the SESC, which is bound to make a public accounting of its activities, the JSDA does not publish detailed information of its regulatory activities citing privacy concerns.<sup>120</sup> The SESC does, however, oversee the JSDA and provides a yearly summary of JSDA activities from reports submitted by the JSDA.<sup>121</sup> What is most remarkable about this summary are the numbers. In the eight year period from 1992 to 2000, the JSDA expelled only one member, issued twelve reprimands, and assessed sixty-three fines,<sup>122</sup> averaging less than ten sanctions per year. Of these JSDA fines and reprimands, officials state "many" are based on inspections conducted by the SESC and their resulting administrative sanctions.<sup>123</sup>

The number of sanctions administratively processed by the JSDA stands in sharp contrast to the sanctions imposed on its own authority. In 1997 alone, the JSDA processed sanctions originating in the Prime Minister's Office and other governmental agencies that canceled the registrations of seventy-four individuals and suspended another ninety-two.<sup>124</sup> In the same year, the JSDA processed reports of internal investigations and sanctions by securities companies and revoked the licenses of an additional eighty persons.<sup>125</sup> The small number of independent

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120. Interview with JSDA officials, in Tokyo, Japan (Sept. 3, 1999).

121. See, e.g., SESC, 1993 ANNUAL REPORT 58; SESC, 1994 ANNUAL REPORT 99. While the JSDA does not make public information about its investigations, it does publish numerical information about its regulatory activities in its Annual Reports (*jigyōhōkokusho*). See *Nihon Shōkengyō Kyōkai*, HEISEI 4 NENDO JIGYŌ HOKOKUSHO 37 [JSDA, 1992 ANNUAL REPORT], JSDA, 1993 ANNUAL REPORT 38; JSDA, 1994 ANNUAL REPORT 28; JSDA, 1995 ANNUAL REPORT 19; JSDA, 1996 ANNUAL REPORT 21; JSDA, 1997 ANNUAL REPORT 26; JSDA, 1998 ANNUAL REPORT 29.

122. SESC, 1993 ANNUAL REPORT 58; SESC, 1994 ANNUAL REPORT 99; SESC, 1995 ANNUAL REPORT 58; SESC, 1996 ANNUAL REPORT 85; SESC, 1997 ANNUAL REPORT 67; SESC, 1998 ANNUAL REPORT 103-104; SESC, 1999 ANNUAL REPORT 8(2); SESC, 2000 ANNUAL REPORT 9(2). Almost half of this total came in JSDA regulatory activity in 1999 and 2000, the year of and after, it was audited by the SESC. See reports cited *supra* this note.

123. *Id.* The numbers are incomplete. Between 1992 and 1997, seventeen of thirty-two, or over 50%, of JSDA sanctions followed SESC activity. Since 1997, the SESC has not broken down the number of JSDA sanctions based on SESC inspections, but JSDA officials have stated informally that "many" of the JSDA sanctions are based on or completed in conjunction with SESC investigations and sanctions. See SESC, 1998 ANNUAL REPORT 103-04; Interview with JSDA official, in Tokyo, Japan (Sept. 3, 1999). See also *NIHON SHŌKENGYŌ KYŌKAI, KYŌKAI UNEI NI KANSURU KONDANKAI*, 6 (Jan. 1999), available at <http://www.jsda.or.jp> (last visited Aug. 12, 1999).

124. The JSDA processes administrative sanctions based on a grant of authority found in SEL Section 64-3(1). Figures are also available for 1996 when the JSDA canceled the registration of ninety-three and suspended eighty-nine under SEL Section 64-3(1). See JSDA, 1997 ANNUAL REPORT 26.

125. *Id.* The JSDA processes member sanctions based on Rule No. 8 of JSDA Rules of Fair Practice, the Rule Concerning Securities Employees, Section 13. In

sanctions imposed by the JSDA, relative to its processing of sanctions, tells only part of the story. The fact that roughly half of the sanctions it imposed came only after investigations by the SESC speaks to the subject of JSDA inspections.

## 2. JSDA Sanctions and Problems "Recognized"

As with the SESC, there are conspicuous gaps in the enforcement of rules governing transactions with the individual investor in the retail market. In looking at the violations detailed in the SESC summaries, there are no findings of misrepresentation or fraud as defined in the JSDA Rules of Fair Practice.

Rule No. 8 Section 9-2 requires that members supervise their employees, so as to prevent "the kind of solicitation which would cause a customer to misunderstand the nature of the transaction or its terms,"<sup>126</sup> and "the kind of solicitation which would cause a customer to misunderstand about the rise or fall of the price of a security." The section has not been invoked.<sup>127</sup>

There are multiple suitability rules. Section 3 of the JSDA's Summary of Ethics (*rinri kōryō*) states that "in light of the importance of the individual investor in the market, [members] are to solicit investment that is suitable to the investor's investment goals, their knowledge and financial condition." In addition, they are to "endeavor to provide objective investment information based on accurate information and data so as not to place the individual investor in a disadvantageous position."<sup>128</sup> The Rule Concerning Transactions in Foreign Securities states "when soliciting investment in foreign securities from customers, [mem-

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1996, the JSDA canceled or suspended the registration of another 106 based on this rule. *Id.*

126. Rules Concerning Securities Employees, Rule 8 § 9-2(2), JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 251.

127. Rules Concerning Securities Employees, Rule 8 § 9-2(3), JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 252.

128. The JSDA adopted its Articles of Association and Summary of Ethics on Aug. 23, 1991. In addition to Section 3, Section 2 provides a general duty of good faith. Members are to "conduct business fairly and in good faith, standing in the place of the customer, and as a matter of course giving great weight to the customers' needs and interests." Section 4 requires members to strictly comply with the rules and regulations and "through appropriate solicitation of investment and transactions based on the investors' independent decisions, work to establish the principal of self responsibility." SHOKEN KANKEI HOREI KENKYŪKAI HEN, SAISHIN SHOKEN KANKEI HŌKI RUISSHŪ (DAI 2 KAN) 3203 (1998). These ethical provisions are not without effect. Section 14 of the Rule Concerning the Enforcement of the Articles of Association provides that violations of the duty of good faith include actions which "cause a loss of confidence" in the Association or member, or "actions which are in contravention of good faith." Examples provided include "in conjunction with the purchase or sale of securities, or other transactions, fraudulent actions, actions which are in bad faith or improper, or a conspicuous failure to exercise care or negligently conducting business." *Id.* at 3220.

bers are to] provide sufficient consideration so investments are made that are suited to the customer's intent, investment experience and financial resources."<sup>129</sup> The Rule Concerning Member Solicitation of Investment and Maintenance of Customer Accounts requires as a general rule that members "must endeavor to sufficiently understand the customer's investment experience, investment objectives, and financial means, and solicit investment that is suited to the customers' intent and circumstances."<sup>130</sup> As with the SEL, the rules are not stated as flat prohibitions, but they can be enforced through the JSDA's broad authority under Articles 25 and 26 of the Articles of Association.<sup>131</sup> Notwithstanding such authorization, there is no mention in the JSDA reports published by the SESC of any sanction for the recommendation of an unsuitable transaction.

The rule regulating solicitation of transactions has, through successive revisions, made explicit the member's duty to explain.<sup>132</sup> Section 6 requires members to "provide written explan-

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129. Rule Concerning Transactions in Foreign Securities, JSDA Rules of Fair Practice, Rule 4 § 5. Section 6 goes on to state that when accepting an order, the member "must have the relevant customers submit. . . written documentation stating that [the order] is based upon the customer's intent." JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 162.

130. Rule Concerning Member Solicitation of Investment and Customer Supervision, JSDA Rules of Fair Practice, Rule 9 § 2(2), JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 267.

131. In order to prevent solicitation of unsuitable investments, standards are to be established for customers engaging in margin transactions, warrant transactions, futures transactions, and other high-risk products. Members are to "establish minimum standards for the respective transactions," including standards for the "customer's investment experience, assets invested by the customer, and other factors deemed necessary by the member." JSDA Rules of Fair Practice, Rule 9 § 5(1) and 5(2), SHOKEN KANKEI HOREI KENKYUKAI HEN, *supra* note 128, at 3295, 3296.

132. Rule Concerning Member Solicitation of Investment and Maintenance of Customer Accounts, JSDA Rules of Fair Practice, Rule No. 9 §§ 6 to 6-5, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 176. Rules No. 4 and 5 also include a duty to explain. Rule 4 Section 9 provides that "solicitation can be conducted based on the provision of written materials explaining the nature of the foreign security," and with the 1998 revision, Section 12 (3) states, "members, when accepting orders for transactions. . . in foreign securities, must explain to the customer that with regard to the relevant foreign stock, disclosure of corporate information is not conducted based on the Japanese Securities Exchange Law." SHOKEN KANKEI HOREI KENKYUKAI HEN, *supra* note 128, at 3253-54. Rule No. 5, the Rule Concerning the Purchase and Sale of Listed Securities Outside of Securities Exchanges was enacted in 1998. Section 14 provides that when accepting an order for an off-exchange transaction from a customer, unless the customer has previously conducted like transactions within the past year, the member must in advance "provide written explanatory materials, and adequately explain them." The materials must state the structure of the transaction and the matters necessary for the transaction to be conducted based on the customer's independent decision and responsibility. Section 15 of Rule No. 5 also requires that members make clear the form of the transaction, and publishes exchange and off-exchange price information, the commissions to be borne by the customer, and other relevant matters relating to transfer

atory materials and sufficiently explain their contents” to first-time customers in margin transactions and new public offerings, and when receiving an order for a margin transaction, explain each time the differences in terms and “confirm the relevant customer’s intent.”<sup>133</sup> Section 6-3 was revised in 1998 to add that, for customers completing contracts for warrants or futures transactions, the members “provide to the relevant customer in advance written explanatory materials stating a summary of the transaction, matters relating to the risk of loss in the transaction, and other matters requiring the attention of the customer . . . and sufficiently explain these issues.”<sup>134</sup> Members must then obtain from the customer a written confirmation of understanding.<sup>135</sup> Section 6-4 requires that for first-time customers trading in securities handled over-the-counter, members “must sufficiently explain the nature and structure of the transaction” as well as obtain a written confirmation of understanding.<sup>136</sup> With a 1998 revision, even investment trusts are subject to a clear duty to explain. The “nature of the product must be sufficiently explained,” and the prospectus must be provided or sent according to methods delineated in the rules.<sup>137</sup>

The JSDA’s Rules of Fair Practice go in to great detail delineating the parameters of members’ duties to avoid misleading representations, avoid unsuitable recommendations, to explain the structure and risks of the investment instrument, to provide

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and settlement. *See* JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 210.

133. Rule Concerning Member Solicitation of Investment and Customer Supervision, Rule 9 § 6 (1) (2), JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 268.

134. Transactions with customers who have received the materials within the previous year are exempted. Rule Concerning Member Solicitation of Investment and Customer Supervision, Rule 9 § 6-3, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 268.

135. *Id.*

136. Rule Concerning Member Solicitation of Investment and Customer Supervision, Rule 9 § 6-4, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 268. Section 6-2 was established in 1996 and revised in 1998 to include a clear duty to explain for first-time customers trading in “over-the-counter stocks subject to special rules.” Members “must sufficiently explain the nature of the relevant stock and the gist of the registration standards.” Rule Concerning Member Solicitation of Investment and Customer Supervision, Rule 9 § 6-2, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 268.

137. Rule Concerning Member Solicitation of Investment and Customer Supervision, Rule 9 § 6-4, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 268. In addition, Section 6-5 (2) provides that financial institutions that are special members must, when soliciting the sale of investment trusts and in order to “ensure there is no mistaking securities with deposit accounts and the like, provide written materials, or by other appropriate means, must sufficiently explain the items delineated in the rules.” JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 269.

written explanatory materials, and in many cases obtain written confirmation of the investor's understanding. Nonetheless, JSDA reports make no mention of any sanctions for violations of these rules.<sup>138</sup>

In lieu of sanctions, the JSDA, like the SESC, has made a practice of focusing on specific areas, acknowledging problems, and in a few instances providing remedial guidance. Three areas in particular have received attention: "compliance with the suitability principle," "compliance with rules regarding actions prohibited in transactions for the purchase and sale of securities," and "management of accounts and transactions."<sup>139</sup> The details of the violations found, however, belie the nature of their categorization.

Violations covered under the suitability principle include the failure, delay, or incomplete recording of the "customer's card";<sup>140</sup> delay in obtaining from the customer the required written confirmation of understanding of the transaction; and delay or impropriety in providing transaction and account statements.<sup>141</sup> The violations noted are self-evident from the record and bear only a superficial relationship to substantive suitability issues. Making an unsuitable recommendation to the investor is absent from the list.

Notwithstanding the detailed duty to explain and prohibition against misleading statements found in the JSDA Rules of Fair Practice, compliance violations cited by the JSDA are similarly limited. They include inappropriate loans to customers, failure to confirm the customer's identity, knowing acceptance of orders placed under fictitious names or in borrowed accounts, ac-

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138. SESC, 1993 ANNUAL REPORT 55; SESC, 1994 ANNUAL REPORT 97-8; SESC, 1995 ANNUAL REPORT 55; SESC, 1996 ANNUAL REPORT 82; SESC, 1997 ANNUAL REPORT 64-5; SESC, 1998 ANNUAL REPORT 101-02.

139. SESC, 1993 ANNUAL REPORT 55; SESC, 1994 ANNUAL REPORT 97-8; SESC, 1995 ANNUAL REPORT 55; SESC, 1996 ANNUAL REPORT 82; SESC, 1997 ANNUAL REPORT 64-5; SESC, 1998 ANNUAL REPORT 101-02. 1998 brought a fourth area of focus, an examination of members' development and maintenance of internal standards and guidelines. See SESC, 1999 ANNUAL REPORT 8(2). In 1999 this focus shifted to members' separation of holdings. See SESC, 2000 ANNUAL REPORT 9 (2).

140. Rule 9 Section 4 provides that members must maintain "customer cards" or customer records for customers purchasing and selling securities or other transactions. These cards are to include: 1) the name, address, and contact information for the customer, 2) the age and occupation, 3) investment objectives, 4) financial condition, 5) experience or lack thereof in securities investment, 6) type of transactions, 7) motive for becoming a customer, 8) method for confirming the identity of the customer, and 9) other items considered necessary by the member. See JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 267.

141. SESC, 1993 ANNUAL REPORT 55; SESC, 1994 ANNUAL REPORT 97-8; SESC, 1995 ANNUAL REPORT 55; SESC, 1996 ANNUAL REPORT 82; SESC, 1997 ANNUAL REPORT 64-5; SESC, 1998 ANNUAL REPORT 101-02.

tivities by unlicensed brokers, failure to disclose short selling, and failure to follow accident reporting procedures.<sup>142</sup> Again, these are violations limited to paper infractions and do not address substantive fraud against individual investors.

Under the category of management of accounts and transactions, violations include delay or failure to prepare insider transaction forms; delay or failure to provide certificates of deposit for securities held; delay or failure to obtain deposits for bids placed; failure to segregate orders placed as an agent from those placed for the securities company's own account; and failure to fill out order slips.<sup>143</sup> The emphasis remains on the superficial.

In contrast to the handful of JSDA reprimands and sanctions discussed earlier, each of these rule violations did not rise to the level of a reprimand or sanction, but were further segregated: "Among these rule violations, where a particular need for improvement is recognized, a report on the improvements made is requested, and the necessary guidance for improvement is conducted."<sup>144</sup> In other words, even among the limited violations found, in many cases no action was deemed necessary.

A pattern emerges in looking at JSDA regulatory activity. As with the SESC, there is an abiding interest in the paper record, and a corresponding lack of activity in the area of substantive fraud encountered by the general investor. The suitability principle is interpreted only in terms of documentation. Fraud is reduced to mistakes in the maintenance of customer and transaction records, and insider trading is viewed through the limited prism of paper generated. There is regulation and rule-making but little enforcement, with few reprimands and sanctions imposed independently by the JSDA. Of those sanctions that are issued, most follow on the heels of SESC action, and the role of the JSDA is clearly secondary to that of the SESC. The JSDA's independent regulatory role is overshadowed by its emphasis on administrative duties and processing the sanctions imposed by others.

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142. SESC, 1993 ANNUAL REPORT 55; SESC, 1994 ANNUAL REPORT 97-8; SESC, 1995 ANNUAL REPORT 55; SESC, 1996 ANNUAL REPORT 82; SESC, 1997 ANNUAL REPORT 64-5; SESC, ANNUAL REPORT 101-02; SESC, 1999 ANNUAL REPORT 8(2); SESC, 2000 ANNUAL REPORT 9(2).

143. SESC, 1993 ANNUAL REPORT 55; SESC, 1994 ANNUAL REPORT 97-8; SESC, 1995 ANNUAL REPORT 55; SESC, 1996 ANNUAL REPORT 82; SESC, 1997 ANNUAL REPORT 64-5; SESC, 1998 ANNUAL REPORT 101-02; SESC, 1999 ANNUAL REPORT 8(2); SESC, 2000 ANNUAL REPORT 9(2).

144. SESC, 1993 ANNUAL REPORT 82; SESC, 1997 ANNUAL REPORT 65; SESC, 1998 ANNUAL REPORT 102; SESC, 1999 ANNUAL REPORT 8(2); SESC, 2000 ANNUAL REPORT 9(2). The number of securities companies asked by the JSDA to file reports documenting remedial steps taken has varied from seventeen in 1995 to thirty-eight in 1997.

### C. ALTERNATIVE DISPUTE RESOLUTION

While much has been made of alternative dispute resolution in Japan,<sup>145</sup> it bears mention in the context of securities disputes for two reasons. First, the information available belies the conventional wisdom that in resolving private disputes, mediation and conciliation have surpassed or usurped the role of the judiciary. Second, it further illustrates the lack of involvement by regulatory agencies and self-regulatory organizations in the formation of legal standards and remedies.

Until recently, Section 172 of the SEL provided that "in the event of a dispute, in order to promote the resolution of the dispute, the parties involved may apply to the Minister of Finance and request intermediation (*chūkai*)."<sup>146</sup> Officials within the MOF's Securities Bureau and the Regional Financial Bureaus would then hold hearings, draft an agreement, and make recommendations to the parties involved.<sup>147</sup> The good offices of the bureaucrats within the MOF, however, were not freely offered or well received. Approximately ten cases have been reported,<sup>148</sup> with practitioners commenting on a general reluctance by the parties to involve the government, refusal by the MOF to even accept cases (*monzenbarai*) and a bias toward the industry when cases were accepted.<sup>149</sup> The system was abolished in 1998.<sup>150</sup>

The alternative dispute resolution services provided by the JSDA have fared little better. The SESC and JSDA both actively refer investor disputes to the JSDA's mediation program.<sup>151</sup> In doing so, issues related to active investor disputes become not regulatory issues but issues for alternative dispute resolution. In

145. English language discussion of alternative dispute resolution in Japan began in many ways with Dan Fenno Henderson's seminal work on Japanese conciliation and has continued on through the present. See, e.g., DAN FENNO HENDERSON, CONCILIATION AND JAPANESE LAW: TOKUGAWA AND MODERN (1965); PERSPECTIVES ON CIVIL JUSTICE AND ADR (Takeshi Kojima ed., 1980); JOSEPH W. S. DAVIS, DISPUTE RESOLUTION IN JAPAN (1996).

146. SEL § 172, as amended 1997.

147. SEL § 172-79; Kimu Shōshō, *Amerika ni okeru Shōken Torihiki wo Meguru Funsō to Chūsai*, NAGOYA DAIGAKU HŌSEI RONSHŪ No. 147 (1993) 331, 336.

148. Sawai Hiraku, *Beikoku ni Okeru Shouken Chūsai (Ge)* KOKUSAI SHOH HOMU, Vol. 21 No. 8, (1993) 983, 988.

149. Kimu, *supra* note 147, at 336; Sawai, *supra* note 148, at 989-90.

150. Sections 172 through 185 of the SEL were repealed effective 1999. See SEL as amended 1999.

151. The SESC states, "with regard to disputes between securities companies and investors, where parties request concrete resolution, because the Japan's Securities Dealers Association provides a system for resolving disputes, [the SESC] as appropriate introduces the Association's Securities Complaints Consultation Service." SESC, 1993 ANNUAL REPORT 71; SESC, 1994 ANNUAL REPORT 105-06; SESC, 1995 ANNUAL REPORT 63-4; SESC, 1996 ANNUAL REPORT 91-2; SESC, 1997 ANNUAL REPORT 73-4; SESC, 1998 ANNUAL REPORT 79-80; Interview with JSDA official, in Tokyo, Japan (Sept. 5, 1999).

practice, investor disputes generate neither regulatory issues nor ADR cases. Notwithstanding the referrals, investors go elsewhere, and mediation is rare.

Through 1998, the JSDA offered conciliation (*chōtei*) and mediation (*assen*) services,<sup>152</sup> but from 1992 to 1998, the JSDA received only nine conciliation and forty-seven mediation cases.<sup>153</sup> In 1998, the JSDA terminated the conciliation program.<sup>154</sup> With an overall average of eight cases per year, as compared to the hundreds of disputes handled by the courts during the same period,<sup>155</sup> the JSDA has not functioned effectively as a dispute resolution body. Furthermore, even with procedural amendments in 1998, expectations for its role in the future are not high. Practitioners have commented that “regardless of the efforts of outside advisors, the recently legislated JSDA mediation program will, honestly speaking, not be trusted by the consumer.”<sup>156</sup>

In the period spanning the end of the Bubble and through the first few years of the Big Bang, the SESC and the JSDA have played a limited role, both in providing remedies and fashioning legal norms for transactions between the general investor and securities companies.<sup>157</sup> The SESC and JSDA, while addressing in-

152. The former “Rule Concerning Conciliation and Mediation for the Resolution of Disputes Between Members and Customers” was amended in 1998 and is now titled “Rule Concerning Mediation for the Resolution of Disputes Between Members and Customers.” See JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 547.

153. JSDA, 1992 ANNUAL REPORT 37, 43; JSDA, 1993 ANNUAL REPORT 44; JSDA, 1994 ANNUAL REPORT 36; JSDA, 1995 ANNUAL REPORT 36; JSDA, 1996 ANNUAL REPORT 33; JSDA, 1997 ANNUAL REPORT 38; JSDA, 1998 ANNUAL REPORT 43.

154. JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 13, 17. The conciliation program was abolished because it was thought redundant. As a matter of course, JSDA dispute resolution offices first attempted resolution through mediation, and if that failed, then through conciliation, which at that point was often futile. Interview with JSDA Hokkaido District official, in Sapporo, Japan (Aug. 3, 1999). In addition, the 1998 revision of the SEL provided a specific legal basis for the JSDA’s mediation (*assen*) program. See SEL § 79-16(2); JSDA Articles of Association Art. 69, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 547; Rule Concerning the Mediation of Dispute Resolution between Association Members and Customers, JSDA, ARTICLES OF ASSOCIATION AND RULES, *supra* note 118, at 547-57.

155. As of October 1997, the four major securities companies, Nomura Securities, Daiwa Securities, Nikko Securities, and the now defunct Yamaichi Securities, were engaged in no fewer than 225 law suits. In comparison, in the 1997 fiscal year, the JSDA mediated only 4 cases. See 4 *Dai Shōken he Baishō Seikyū 223 ken, Kei 472 Okuen, Ooku ga Waranto Karami*, ASAHI SHINBUN CHOKAN, May 20, 1997, at 1; JSDA, 1997 ANNUAL REPORT 38. See also Part II *infra*.

156. Zadankai, *Kinyū Sa-bisu Hō he no Tenbō to Kadai*, KINYŪ HOMU JUJŌ No. 1535 (1999) 31, 52.

157. In suggesting that the SESC has pursued a limited course of regulation and omitted fraud, suitability, the duty to explain, and other issues relevant to the indi-

sider trading and loss compensation, have in large part confined themselves to administrative notice of fraud as found in inspection of records, without enforcing regulations affecting the general investor or providing an alternative dispute resolution forum.

The SESC and the JSDA, as well as other SROs, are said to function together as "wheels on a car" (*iwaba kuruma no ryōrin*).<sup>158</sup> If so, the tires need inflating. With the Bubble economy and its collapse, the need for effective regulation has been great but noticeably absent. It is the Japanese judiciary that has filled the void. The civil justice system in Japan has become the primary forum for the development of legal standards regulating transactions involving the general investor, and has become the only forum providing restitution.

## II. PRIVATE LAW AND A "LITIGATION EXPLOSION"

The judiciary was spurred on by what was, by Japanese standards, a litigation explosion. The combination of a lax regulatory environment and the collapse of the Bubble in the early 1990s produced over one hundred reported judicial opinions involving disputes between general investors and securities companies, including two Supreme Court decisions.<sup>159</sup> During the same period, there were over one hundred reported opinions, again including two Supreme Court decisions, addressing the sale of

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vidual investor, it can be argued that the SESC was established in 1992 after the Bubble's peak and after many individual investors withdrew from the market. While many of the initial transactions preceded the SESC, many of the disputes that have occupied the courts and will be discussed in Part III arose after the SESC was established. Warrant transactions typically expire four or five years after they are issued, so many warrants purchased during the Bubble expired and disputes arose after the establishment of the SESC. *See, e.g.*, Osaka Dist. Ct. Decision, Nov. 24, 1995, HANREI TAIMUZU No. 909 (1996) 193; Niigata Dist. Ct. Decision, Jan. 30, 1996, HANREI TAIMUZU No. 897 (1996) 161; Tokyo Appellate Court Decision, Mar. 18, 1996, HANREI TAIMUZU No. 923 (1997) 146; Sendei App. Ct. Decision, Oct. 14, 1996, KINYŪ SHŌJI HANREI No. 1009 (1997) 18; Hiroshima App. Ct. Decision, June 12, 1997, HANREI TAIMUZU No. 971 (1998) 170; Tokyo Dist. Ct. Decision, Nov. 11, 1997, KINYŪ SHŌJI HANREI 1031 (1998) 37; Fukuoka App. Ct. Decision, Feb. 27, 1998, HANREI TAIMUZU No. 992 (1999) 138. In addition, after the collapse of the Bubble, securities companies turned to investment trusts as the investment product of choice precipitating numerous disputes, again resolved by the court. *See, e.g.*, Kobe Dist. Ct. Decision, July 18, 1996, HANREI TAIMUZU No. 927 (1997) 176; Osaka App. Ct. Decision, May 30, 1997, KINYŪ SHŌJI HANREI No. 1030 (1997) 19; Tokyo Dist. Ct. Decision, Feb. 23, 1998, KINYŪ SHŌJI HANREI No. 1051 (1998) 49.

158. SESC, 1993 ANNUAL REPORT 51.

159. *See generally* ZENKOKU SHŌKEN MONDAI KENYŪKAI HEN, SHŌKEN TORIHIKI HIGAI HANREI SEREKUTO Nos. 1-8 (1994-1998).

variable life insurance products, which in contrast to United States law have not been treated as securities.<sup>160</sup>

Statistics are not available for the total number of cases filed relating to investment products, but there have been estimates of over 600 cases filed involving variable life insurance alone.<sup>161</sup> Information on the total number of securities related disputes filed is equally sketchy but suggests the numbers are significant. A 1992 survey by the Securities Bureau of the Ministry of Finance found over 300 securities related lawsuits pending with the alleged damages totaling over 59 billion yen.<sup>162</sup> As of October 1997, the four major securities companies alone were engaged in no fewer than 225 cases involving 47.2 billion yen.<sup>163</sup> By Japanese standards these numbers are enormous, particularly given there was "virtually no securities fraud litigation" prior to the 1990s.<sup>164</sup>

Much of the private litigation involving securities transactions has involved equity warrants.<sup>165</sup> Equity warrants are four or five year options to purchase stock, with the notable exception that they are issued by corporations on their own equity and not by a third party on existing equity.<sup>166</sup> The Japanese warrant mar-

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160. Andrew Pardieck, *Hengaku Hoken ni Kan suru Nihanketsu—Nichibei Tōshisha Hogo no Chikasuimyaku*, HANREI TAIMZU No. 990 (1999) 52, 64. Variable life insurance is partially invested in common stock and provides a death benefit dependent on the insured's portfolio market value at the time of death. These policies were marketed as a means of reducing estate taxes on real estate that had appreciated in value during the Bubble. Insurance companies as well as banks solicited their purchase with funds raised from loans, which were secured by mortgages on the real estate that had appreciated. When the bottom dropped out of both the stock market and the real estate market, investors lost their homes and incidents of suicide among elderly investors were reported. See Sasamoto Yukihiko, *Hengakuhoken no Kanyū ni okeru Setsumei Gimu—Kinji no Saibanrei no Kentō wo Chūshin toshite*, HOKENGAKU ZASSHI No. 554 (1996) 35, 38.

161. Seizawa Masahiki & Ichihara Tsuneo, *Hengaku Hoken Soshō No Haikai to Ronten*, KINYŪ HOMU JUJŪ No. 1465 (1996) 7, 12.

162. Kimu, *supra* note 149, at 335.

163. *4 Dai Shōken he Baishō Seikyū 223 Ken, Kei 472 Okuen, Ooku ga Waranto Karami*, *supra* note 155, at 1.

164. Macey & Kanda, *supra* note 14, at 1043.

165. Warrants can be divided into equity and debt warrants. See KEVIN CONNOLLY & GEORGE PHILIPS, *JAPANESE WARRANT MARKETS 1-2* (1992).

166. See CONNOLLY & PHILIPS, *supra* note 165 at 2, 3, 13. "An equity warrant may be strictly defined as a financial contract, issued by a corporation, which gives the right but not the obligation to purchase a fixed number of the company's underlying shares at a specified/variable price over a given period of time." *Id.* Japanese warrants are "American style warrants" which may be exercised at any point prior to maturity, as opposed to European style warrants which may be exercised only on maturity and are traded over-the-counter. *Id.* Japanese judicial precedent and scholarly opinion have often equated warrants with options for the purpose of their analysis. See, e.g., Hiroshima App. Ct. Decision June 12, 1997, HANREI TAIMZU No. 971 (1998) 170, 171; Osaka App. Ct. Decision, Sept. 13, 1996, HANREI TAIMZU No. 942 (1997) 191, 193. See also Kawahama Noboru, *Waranto Kanyū ni okeru*

ket during the Bubble economy was the largest equity warrant market in history,<sup>167</sup> and warrants were a favored investment vehicle touted by brokers to investors of all shapes and sizes.<sup>168</sup> With the collapse of the bubble economy, securities firms began pushing investment trusts which, along with a few cases involving simple stock transactions and a few options cases, comprise the remainder of the reported decisions.<sup>169</sup>

#### A. SECURITIES FRAUD AS A TORT

In an effort to sell, brokers committed what would be simply classified as fraud under United States securities law.<sup>170</sup> In the go-go days of the bubble economy conclusive evaluations or guarantees that the price was "sure to rise" or would rise to a specified price within a specified time were common, as were cases where a broker sold unsuitable products, or failed to explain the risks involved. However, the courts have not found fraud, but instead articulated a duty of care and held that a significant violation of this duty is a tort and violates Article 709 of the Civil Code.<sup>171</sup>

The decisions almost invariably begin by stating the general premise that investments are inherently risky and investors participate in the market at their own risk. "Self-responsibility" (*jiko sekinin*) is a term that crops up with great regularity in judicial opinions, scholarship, and in the mass media.<sup>172</sup> The deci-

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*Shōken Kaisha no Setsumei Gimu*, MINSHŌ HŌ ZASSHI Vol. 113 No. 4•5 (1996) 633, 637; Yamashita Tomonobu, *Shōken Tōshi no Kanyū to Setsumei Gimu—Waranto no Tōshi Kanyū wo Chūshin to Shite*, KINYŪ HŌMU JIJŌ No. 1407 (1995) 25.

167. CONNOLLY & PHILIPS, *supra* note 165, at xiii. The Japanese warrant market was born in 1981 and by 1989 Japanese corporations raised 2.9 times more capital through issuance of warrant and convertible bonds than they did from equity offerings. *Id.*

168. See discussion of administrative cases *supra* Part I and civil cases *infra* Part II.

169. See discussion of administrative cases *supra* Part I and civil cases *infra* Part II.

170. See *infra* note 185.

171. Article 709 provides that "[a] person who violates intentionally or negligently the right of another is bound to make compensation for damages arising therefrom." In a few instances plaintiffs have alleged and courts found breach of contract based on a failure to explain. Pursuant to Section 415: "If an obligor fails to effect performance in accordance with the tenor and purport of the obligation, the obligee may demand compensation for damages. . . ." MINPŌ [Civil Code], Law No. 89 of 1896 *as amended*, EHS LAW BULLETIN SERIES Vol. II FA-FAA (1961). Damages awarded in such cases are typically the loss to principal. As with other actions in tort, interest and a partial award of attorney's fees, typically 10% of total damages awarded, are common. See Shimuzu Toshihiko, *Tōshi Kanyū to Fuhōkōi (4)—Waranto Tōshi Kanyū to Setsumei Gimu*, HANREI TAIMUZU No. 936 (1997) 82, 101-02, 113.

172. See, e.g., Tokyo Dist. Ct. Decision, May 12, 1993, HANREI JIHŌ No. 1466 (1993) 105, 109 ("Securities transactions are transactions accompanied by inherent

sions though go on to state that given the risk and complexity of the investment products and the disparity between the securities broker and the investor in information and ability to process that information, investor reliance on the expertise of the securities company is worthy of protection.<sup>173</sup> In doing so, reference is made to the SEL and related regulations that provide specific investor protection measures. As a civil law regime, there is a sharp delineation between public and private law (*kōhō•shihō no shunbetsu*)<sup>174</sup> precluding direct recognition of an implied private right of action for a violation of the SEL.<sup>175</sup> However, recent decisions tend to review the public law and, in light of it, recognize a duty which is actionable under the private law regime in the Civil Code.<sup>176</sup>

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risk . . . the investors themselves should make an independent decision regarding the risks of the relevant transaction, and whether they possess the necessary financial fundamentals to withstand the risk, and conduct the transaction based on their own responsibility (the so-called principle of self-responsibility) . . .”; Osaka Dist. Ct. Decision, Feb. 10, 1994, HANREI TAIMUZU No. 841 (1994) 276, 281 (“Generally, securities transactions carry with them risk . . . the investors themselves, based on the previously mentioned information, on their own responsibility should conduct transactions, deciding whether the relevant transaction contains risk, its degree, and in addition whether or not they possess the financial basis to withstand this risk (the principle of self-responsibility) . . .”). See also NIHON SHŌKEN KEIZAI KENKYŪJO, SHŌKEN TORIHIKI NI OKERU JIKO SEKININ GENSOKU TO TŌSHISHA HOGO (1996); *Kinyū Shōhin Hanbai, Kanyū Shuhō no Kaiji Gimuka Shōhisha Hogo no Gutaian Katamaru*, ASAHI SHINBUN CHŌKAN, Dec. 4, 1999 at 1; *Kinyū Shōhin Shinhō, Kanyū Kisei ni Kadai Gyōseibatsu nado ha Mōkezu*, ASAHI SHINBUN CHŌKAN, Dec. 22, 1999, at 12; Hagiwara Hiroko, *Kinyū Shōhin Hanbai Hō ha Yūkō ka*, ASAHI SHINBUN CHŌKAN, Feb. 16, 2001, at 14; *Shōhisha no Rieki Mamoru ‘Keiyakuhō’ (Seikatsu Daiyaru)*, ASAHI SHINBUN CHŌKAN, Mar. 8, 2001, at 34.

173. See, e.g., Tokyo Dist. Ct. Decision, May 12, 1993, HANREI JIHŌ No. 1466 (1993) 105; Osaka Dist. Ct. Decision, Feb. 10, 1994, HANREI TAIMUZU No. 841 (1994) 276; Osaka Dist. Ct. Decision, Mar. 30, 1994, HANREI TAIMUZU No. 855 (1994) 220; Osaka Dist. Ct. Decision, June 13, 1995, HANREI TAIMUZU No. 890 (1995) 172; Tokyo App. Ct. Decision, July 10, 1997, HANREI TAIMUZU No. 984 (1992) 201.

174. JOHN H. MERRYMAN, THE CIVIL LAW TRADITION 63, 68, 91 (1985) (“Law is divided up into clearly delimited fields. Public law and private law. . . are treated as inherently different and clearly distinguishable.”).

175. The violation of a legal standard, administrative guidance, or the rules of fair practice does not *ipso facto* result in a finding of illegality under private law norms. See ŌMURA ATSUSHI, SHOHISHA HŌ 110 (1998).

176. The judiciary looks to public law and regulation for relevant standards. See Osaka Dist. Ct. Decision, Sept. 14, 1994, HANREI TAIMUZU No. 875 (1994) 171, 184 (“[L]ooking superficially at whether or not these rules have been violated does not determine the existence or nonexistence of private law illegality. However, given the need for investor protection discussed earlier and the background and circumstances of the establishment and intent of the respective rules that have made concrete the requirements for investor protection,” a significant degree of investor protection is mandated and private law duties should be recognized.); Osaka App. Ct. Decision, Feb. 18, 1994, HANREI JIHŌ No. 1524 (1995) 51, 55 (finding “the appellee Mr. Yamamura’s actions were violations of the Securities Exchange Law, the previously mentioned Ministry of Finance Ordinances, and the previously men-

The duty of care in the context of securities transactions has come to be articulated as three distinct duties, each addressing the three prevalent forms of fraud discussed earlier.<sup>177</sup> First, there is a duty not to provide conclusive evaluations regarding the profitability of a transaction or otherwise provide false or misleading information that may impair the ability of the investor to make an accurate assessment of the risk involved.<sup>178</sup> Second, brokers have a duty to avoid actively soliciting investments that, in light of the investor's finances and experience, clearly expose them to excessive risk.<sup>179</sup> Finally, there is a duty in the course of the investor's decision-making process to provide and explain necessary information about the product and the risk it entails.<sup>180</sup>

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tioned Rules of Fair Practice. . . taken as a whole the acts violated the rule of law (*hō chitsujo*), and contained an illegality which fulfilled the requirements of a tortious act." See also Tokyo Dist. Ct., Oct. 20, 1988, KINYŪ SHOJI HANREI No. 813 (1989) 24; Tokyo Dist. Ct. Decision, May 12, 1993, HANREI JIHO No. 1466 (1993) 105; Osaka Dist. Ct. Decision, Oct. 13, 1993, HANREI JIHO No. 1510 (1995) 130; Osaka Dist. Ct. Decision, Feb. 10, 1994, HANREI TAIMUZU No. 841 (1994) 276; Niigata Dist. Ct. Decision, Apr. 13, 1995, HANREI TAIMUZU No. 876 (1995) 209; Osaka App. Ct. Decision, Apr. 20, 1995, HANREI TAIMUZU No. 885 (1995) 207; Osaka Dist. Ct. Decision, May 30, 1997, KINYŪ SHOJI HANREI No. 1030 (1997) 19.

177. Most often, an enumeration of these three duties in the "general theories" section (*sōron*) of the judicial opinion prefaces case specific analysis. See, e.g., Osaka Dist. Ct. Decision, Mar. 30, 1994, HANREI TAIMUZU No. 855 (1994) 220; Tokyo Dist. Ct. Decision, Aug. 30, 1995, HANREI TAIMUZU No. 911 (1996) 163; Tokyo Dist. Ct. Decision, Oct. 26, 1995, HANREI TAIMUZU No. 915 (1996) 223, 226.

178. *Id.*

179. *Id.*

180. While judicial and scholarly opinion have been almost unanimous in formulating the broker's duty of care as three distinct civil law duties, a number of opinions addressing a variety of transactions have begun imposing an additional duty of reasonableness (*gōrisei*) in solicitation. The requirement is similar to the shingle theory in the U.S. with its requirement of a reasonable basis for broker's opinions. See *supra* note 104. A notable difference is that in Japan the duty arises in the context of private securities litigation, as opposed to administrative actions, and scienter is not a prerequisite. See, e.g., Tokyo Dist. Ct. Decision, Sept. 17, 1990, HANREI JIHO No. 1387 (1991) 98, 105 (In a dispute over an initial public offering, the court found "securities companies. . . possess a wealth of experience, information, and high level of expertise, and as a result, the general customer makes their investment decision relying on the existence of what is in its own way reasonable grounds for the securities company's recommendation. . . . Thus, this customer's reliance is deserving of sufficient protection, and when the securities company recommends to a customer a securities transaction it must not convey opinions or facts without a reasonable basis, and if it does so. . . in the event it causes a customer to sustain losses as the result of influencing the customer's decision to invest, the securities company must compensate the customer for its losses."); Nagoya Summary Court Decision, June 30, 1993, KINYŪ SHOJI HANREI No. 943 (1994) 38, 41 (In a dispute over a warrant transaction, the court held the general investor relies on the existence of "reasonable grounds" for the security company's recommendation and this reliance is "deserving of sufficient protection."); Tokyo Dist. Ct. Decision, Apr. 18, 1995, HANREI JIHO No. 1570 (1996) 81, 83 (In a dispute over a stock purchase, the court found the broker "had no grounds for recommending the stock," and "the recommendation itself misled" the investor and was a tortious act.); Osaka Dist. Ct.

In a dispute involving the sale of an investment trust, an Osaka court stated the securities companies' duty of care as follows: "There is a duty to refrain from soliciting investments by giving conclusive evaluations and the like, to consider the investment's suitability, as well as provide an appropriate explanation regarding the nature and risks of the investment."<sup>181</sup> In short, there is a duty not to mislead, not to solicit unsuitable transactions, and to explain the risks.

As these duties have gained acceptance, courts have dispensed with review of the statutory basis and simply find the duties inherent in the Civil Code.<sup>182</sup> Of greater importance is that recent decisions have omitted the first two duties and focused exclusively on the "duty to explain," both in its application and scope.<sup>183</sup>

## B. THE DUTY NOT TO MISLEAD

Early decisions analyzing a broker's duty not to mislead are straightforward. Section 42 of the SEL and the Order Concerning the Regulation of Acts of Securities Companies clearly prohibit the provision of conclusive evaluations, false representations, and representations that would cause misunderstanding of material facts.<sup>184</sup> The courts in turn have imposed a duty of care on the part of the securities company not to mislead

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Decision, June 28, 1996, HANREI JIHŌ No. 1593 (1997) 87, 91 (in a dispute over a warrant transaction, the court incorporated a reasonable basis requirement into the duty to explain finding the broker's explanation and recommendation of a specific warrant "in itself irrational."); Osaka App. Ct. Decision, Jan. 28, 1997, KINYŪ•SHŌJI HANREI No. 1023 (1997) 19, 23 (when soliciting a high-risk warrant transaction, the broker must "sufficiently explain their reasonable basis for believing the transaction is suitable for the customer."); Osaka App. Ct. Decision, June 24, 1997, HANREI TAIMUZU No. 965 (1998) 183, 189 (in recommending a warrant whose exercise price has fallen below the stock price the broker "must explain based on objective information separately, concretely, and carefully the basis and degree of certainty" for believing the transaction will be profitable); Tokyo Dist. Ct. Decision, Dec. 20, 1993, KINYŪ•SHŌJI HANREI No. 944 (1994) 47, 51 (finding broker's representations had a reasonable basis, and holding there was no breach of the duty not to guarantee a specific rise in the price of a stock).

181. Osaka Dist. Ct. Decision, June 13, 1995, HANREI TAIMUZU No. 890 (1995) 172, 182.

182. See, e.g., Nara Dist. Ct. Decision, Oct. 5, 1995, HANREI TAIMUZU No. 911 (1996) 155, 162; Hiroshima App. Ct. Decision, May 31, 1996, HANREI JIHŌ No. 1594 (1997) 90, 93. See also Shimizu Toshihiko, *Tōshi Kanyū to Fuhōkōi (4)—Waranto Tōshi Kanyū to Setsumei Gimū*, HANREI TAIMUZU No. 936 (1997) 82, 87.

183. See, e.g., Tokyo App. Ct. Decision, July 10, 1997, HANREI TAIMUZU No. 984 (1998) 201, 206; Fukuoka App. Ct. Decision, Feb. 27, 1998, HANREI TAIMUZU No. 992 (1999) 138, 141.

184. See *supra* Part I text accompanying note 58.

as to material facts, and the courts examine any alleged misrepresentations, customer reliance, and resulting losses.<sup>185</sup>

### 1. *Traditional Analysis*

In a 1984 Osaka District Court decision, a broker recommended purchasing on margin a speculative stock that was in play.<sup>186</sup> When asked about it, the broker stated there was no evidence of the stock being in play and the stock was a stock he could "recommend with absolute confidence."<sup>187</sup> It was a "blue-chip stock comparable to Sony and it wouldn't be surprising if the stock reached 5000 yen."<sup>188</sup> After the transaction, the broker strongly discouraged the investor from selling the stock, which then plummeted in value.<sup>189</sup> The court found that it had been widely acknowledged at the time that the stock was in play, and that, in addition, the SEL prohibited the provision of conclusive evaluations about a security's imminent rise or fall in price. The broker "in the context of securities transactions went beyond the bounds of business conduct deemed acceptable by society (*shakai tsūnen*)" and thus was held liable in tort.<sup>190</sup>

A 1993 Osaka District Court similarly held a broker liable in tort after he recommended a stock, stating that he had inside information and that the price "would probably rise to about 3000 yen."<sup>191</sup> The investor invested, and the price tanked.<sup>192</sup> The

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185. The court's duty not to mislead has its basis in SEL Section 42 with its enumerated prohibited acts, but establishes a more general duty not to make false representations or representations which mislead as to material facts. As the cases discussed in the text illustrate, SEL Section 42 and its corresponding civil law duty have been applied to a variety of representations simply categorized as fraud in the U.S. See, e.g., SEC v. Hasho, 784 F.Supp. 1059, 1062, 1108-1109 (S.D.N.Y. 1992) (broker violated the anti-fraud provisions (Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5) in statements including: misrepresentations that the defendants possessed favorable inside information about securities they were recommending; false statements that securities were available for purchase only in certain minimum size blocks; failure to disclose risk factors and negative earnings of issuers or the speculative nature of the securities being recommended; provision of baseless price predictions and profit guarantees including statements customers would recoup past investment losses if they followed defendant's advice; false statements regarding commissions earned on the transactions, and unauthorized trading in customer accounts).

186. Osaka Dist. Ct. Decision, Nov. 29, 1984, HANREI TAIMUZU No. 546 (1985) 154.

187. *Id.* at 159

188. *Id.*

189. *Id.* at 159-60.

190. *Id.* at 160-61 (finding the plaintiff had several years of investment experience and a duty to go beyond the broker's representations and setting off 60% of the damages).

191. Osaka Dist. Ct. Decision, Oct. 13, 1993, HANREI JIHŌ No. 1510 (1995) 130, 134.

192. *Id.* at 135.

court found that, while the broker's statements did not amount to false representations and the broker did not use the terms "guarantee" or "absolute," he had explained things "as if the rise in price to 3000 yen was certain."<sup>193</sup> The broker's conduct was such as to "impede the free and independent judgment of the investor, and at the very least, the broker provided a conclusive evaluation that the price of [the stock] would rise, and based on this impeded the free and independent judgment of the plaintiff."<sup>194</sup> The court found the conduct to be tortious and imposed liability on the securities company for a portion of the damages.<sup>195</sup>

Decisions finding no misrepresentation and hence no liability on the part of the securities company are legion,<sup>196</sup> but there are also decisions that have not imposed liability despite misrepresentations because of the sophistication of the investor and the investor's own duty of care. A 1993 Tokyo District Court opinion is representative.<sup>197</sup> Based on supposed inside information, a broker stated that a stock was to be listed on the Tokyo Stock Exchange, and "a profit of between 1 million and 1.5 million yen gained if 1000 shares are purchased today."<sup>198</sup> The court found "in determining whether the solicitation of a securities broker is or is not a tortious act, one should examine not only whether or not the act of solicitation is an inappropriate solicitation prohibited by the Securities Exchange Law, but specifically examine, from the perspective of societal bounds (*shakai tsūnen*), whether or not the broker's solicitation deviates beyond that which is ac-

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193. *Id.* at 136.

194. *Id.*

195. *Id.* (awarding only 20% of the damages incurred after finding the plaintiff had significant knowledge and experience and was negligent in his reliance on the broker's statements). See also Osaka Appellate Decision, Feb. 18, 1994, HANREI JIHO No. 1524 (1995) 51.

196. See, e.g., Osaka Dist. Ct. Decision, Feb. 10, 1994, HANREI TAIMUZU No. 841 (1994) 276; Osaka Dist. Ct. Decision, Mar. 30 1994, HANREI TAIMUZU No. 855 (1994) 220; Niigata Dist. Ct. Decision, Apr. 13, 1995, HANREI TAIMUZU No. 876 (1995) 209; Tokyo App. Ct. Decision, May 31, 1995, HANREI TAIMUZU No. 897 (1996) 144; Osaka Dist. Ct. Decision, June 13, 1995, HANREI TAIMUZU No. 890 (1995) 172; Tokyo Dist. Ct. Decision, May 30, 1996, HANREI TAIMUZU No. 925 (1996) 224; Nagoya App. Ct. Decision, Oct. 2, 1996, HANREI JIHO No. 1594 (1997) 90; Osaka Dist. Ct. Decision, Nov. 25, 1996, HANREI TAIMUZU No. 940 (1997) 205; Osaka Dist. Ct. Decision, Nov. 27, 1996, HANREI TAIMUZU No. 944 (1997) 185.

197. Tokyo Dist. Ct. Opinion, May 25, 1993, HANREI TAIMUZU No. 851 (1994) 265. See also Tokyo Dist. Ct. Decision, Dec. 20, 1993, KINYŪ SHŌJI HANREI No. 944 (1994) 47; Tokyo Dist. Ct. Decision, Feb. 4, 1994, HANREI TAIMUZU No. 841 (1994) 271; Tokyo Dist. Ct. Decision, Feb. 15, 1994, HANREI TAIMUZU No. 844 (1994) 212; Tokyo App. Ct. Decision, Mar. 30, 1995, HANREI TAIMUZU 885 (1995) 216; Supreme Ct. Decision, Sept. 4, 1997, HANREI TAIMUZU No. 956 (1998) 149; Osaka App. Ct. Decision, Nov. 12, 1998, KINYŪ HOMU JIHO No. 1536 (1999) 35.

198. Tokyo Dist. Ct. Decision, May 25, 1993, *supra* note 197, at 267.

cepted.”<sup>199</sup> Since there was no intent to mislead, and the investor had been a public servant for over twenty years, had extensive investing experience, and made independent decisions,<sup>200</sup> the court found that the solicitation did not go “beyond the bounds deemed acceptable by society” and hence the solicitation was not negligent.<sup>201</sup> This decision found explicit guarantees, the likes of which resulted in liability in other cases; yet, the investor’s sophistication was determinative. The opinion analyzed the conclusive evaluations provided and balanced them against the investor’s experience and knowledge.

## 2. *Emphasis on the Duty to Explain*

Early decisions looked at the misrepresentations, the sophistication of the investor, and whether the broker went beyond the bounds of “conduct deemed acceptable by society,” or made statements so as to “impede the free and independent judgment of the investor.”<sup>202</sup> Recent decisions have analyzed guarantees of profits, conclusive evaluations, and other misleading or fraudulent statements in terms of a violation of the broker’s “duty to explain.”

In a 1995 Kyoto District Court decision, a broker was found to have deleted the fact that the principal of the investment was

199. *Id.*

200. *Id.* at 267-68. The analysis in this case is similar to discussions of the scienter and reasonable reliance requirements in U.S. case law interpreting Section 10(b) of the Securities Exchange Act (15 U.S.C. § 78j(b)) and SEC Rule 10b-5 (17 C.F.R. § 240.10b-5). See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-95 (1976) (requiring scienter, an “intent to deceive, manipulate, or defraud,” but not addressing whether recklessness is sufficient for civil liability under Rule 10b-5); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (finding it well established that recklessness on the part of the defendant would fulfill the scienter requirement for the purposes of Rule 10b-5); *O’Connor v. R. F. Lafferty & Co., Inc.*, 965 F.2d 893, 899 (10th Cir. 1992) (The scienter requirement is met by “conduct that is ‘an extreme departure from standards of ordinary care and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.’”); *Thompson v. Smith Barney, Harris, Upham & Co.*, 709 F.2d 1413, 1418 n.7 (11th Cir. 1983) (“[G]eneral principles of equity suggest that only those who have pursued their own interest with care and good faith should qualify for the judicially created private 10b-5 remedies. . . .”); *Laird v. Integrated Resources, Inc.*, 897 F.2d 826, 837 (5th Cir. 1990) (“[I]n order to demonstrate a violation of Rule 10b-5, the plaintiff must prove . . . due diligence by the plaintiff to pursue his or her own interest with good care and faith.”); *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 632 F.Supp. 471, 485-486 (D. Me. 1986) (finding plaintiff to be a sophisticated investor with a duty to evaluate the broker’s statements, and holding that plaintiff could not have reasonably relied upon any statement made by the broker).

201. Tokyo Dist. Ct. Decision, May 25, 1993, *supra* note 197, at 268.

202. Yamada Seiichi, *Dantei teki Handan o Fukumu Kanyū Kōi to Shōken Kaisha no Fuhōkōi Sekinin*, MINSHO HŌ ZASSHI Vol. 113 No. 4•5 (1996) 188, 202-09.

not guaranteed from investment trust disclosure materials.<sup>203</sup> The court determined that the broker “provided a definitive conclusion that the product in question was a product that did not risk principal” to an inexperienced investor, who had made clear he was interested only in investing in products where the principal was guaranteed.<sup>204</sup> Notwithstanding these conclusions, the court did not find fraud in the alteration of the disclosure materials or a breach of the duty not to provide false or conclusive evaluations.<sup>205</sup> The court instead held that, in light of the investor’s experience, the broker breached “the duty to explain required of a seller when selling a product such as the present one and was negligent.”<sup>206</sup>

A 1997 Tokyo District Court decision similarly found that where a broker misrepresented the risk of warrant transactions to an investor with a junior high school education and no work experience, the broker violated his duty to explain the nature and risks of the transaction.<sup>207</sup> The court found that the broker, in explaining the transaction, stated that “the profits of warrants are three times those of stocks” and that “they can be converted to stocks at any time and have no risk . . . .”<sup>208</sup> Once again, there was no imposition of liability based on the broker’s misrepresentation of the risk, i.e., his blatant falsehood that there was no risk,<sup>209</sup> instead the court focused on the duty to explain. The broker spent twenty to thirty minutes on the phone discussing the transaction; however, his “explanation when soliciting the purchase of the warrant was insufficient and inappropriate.”<sup>210</sup>

One finds in the early cases liability imposed as a result of misrepresentation by a broker, albeit with a significant set-off for

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203. Kyoto Dist. Ct. Decision, May 17, 1995, HANREI JIHO No. 1581 (1996) 92, 96.

204. *Id.* at 96-97.

205. *Id.* at 97.

206. *Id.* at 97, 98 (finding the plaintiffs 80% at fault and awarding only 20% of the losses sustained).

207. Tokyo Dist. Ct. Decision, Sept. 11, 1997, KINYO•SHOJI HANREI No. 1031 (1998) 37, 40, 44.

208. *Id.* at 42.

209. *Id.* at 42-44.

210. *Id.* at 44 (finding no comparative negligence on the part of the plaintiff and awarding damages without set-off). *See also* Osaka Dist. Ct. Decision, Mar. 25, 1996, HANREI TAIMUZU No. 926 (1997) 213; Tokyo App. Ct. Decision July 10, 1997, HANREI TAIMUZU No. 984 (1998) 201. Other opinions have specifically found the broker to have provided conclusive evaluations regarding the movement of the price of a particular stock, and instead of interpreting this as a breach of the broker’s duty to explain, examined the broker’s conduct *in toto* and found it to demonstrate “strong illegality overall, which must be said to equate to tortious conduct under Section 709 of the Civil Code.” Osaka Dist. Ct. Decision, Dec. 20, 1994, HANREI JIHO No. 1548 (1996) 108, 114; *see also* Osaka Dist. Ct. Decision, Feb. 23, 1995, HANREI JIHO No. 1548 (1996) 114, 120.

the plaintiff's contributory negligence.<sup>211</sup> Where a sophisticated or experienced investor is involved, this breach is weighed against the investor's own duty of care, and a finding that the investor's reliance was not reasonable often operates to preclude liability. More recent cases, however, depart from this analysis. The investor's duty of care remains, but the broker's duty not to mislead is reinterpreted. Even where there is clear misrepresentation, such as where the disclosure materials for an investment trust are altered or where an uneducated investor is told warrant transactions have no risk, the misrepresentation is considered as part of an examination of the broker's duty to explain, and liability is premised on a breach of this duty.

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211. A set-off for the contributory negligence of the plaintiff is very common—the rule rather than the exception—and a finding of negligence on the part of the plaintiff of over 51% does not bar recovery. The courts utilize the set-off for contributory negligence to require due diligence by the investor. See Osaka District Court Decision, Oct. 13, 1993, HANREI JIHŌ No. 1510 (1995) 130, 136-37 (In a case involving the provision of a conclusive evaluation, one court found that the plaintiff “should have been aware that the broker's representations. . . were to be no more than references in the formation of the investor's intent and respond accordingly.” The court set off 80% of the plaintiff's damages for negligence in “readily relying on information with a scant basis.”); Tokyo Dist. Ct. Decision, Feb. 15, 1994, HANREI TAIMUZU No. 844 (1994) 212, 220 (The plaintiff “was not in a position where he could not be expected to have made an appropriate decision based on his experience, but in a rash attempt to recover the losses that he had suffered all at once in the present option transactions, and sufficiently aware that [the stocks] were in play, he closed his eyes to the risks involved in the defendant Mr. Kōno's solicitation.” His award was subject to a 70% set-off for contributory negligence.); Osaka App. Ct. Decision, Feb. 18, 1994, HANREI JIHŌ, No. 1524 (1995) 51, 55 (The plaintiff had an education “sufficient to understand the nature of securities transactions,” experience with margin transactions, and “was aware that trying your hand with a stock in play was a generally risky act . . . . Ultimately, the appellant made his own decision to buy the stock and in experiencing losses was also substantially negligent.” His damages were subject to a 70% set-off for contributory negligence.)

Liberal application of contributory negligence principles is not limited to securities transactions, but is an issue in an extremely large percentage of all civil cases. Scholars have acknowledged that Japanese law more readily finds the plaintiff contributorily negligent than is the case in the U.S. See KUBOTA ATSUMI, *KASHITSU SŌSAI NO HORI* (1994); Higuchi Norio, *Kashitsu Sōsai no Nichibei no Kokoromi*, SHIHŌ No. 50 (1988) 110. This has both historical and theoretical roots. “*Kenka ryōseibai*” sums up the former – in a quarrel, both parties are to blame. In Tokugawa, Japan, those seeking enforcement of legal remedies for suffered wrongs were themselves subject to blame and sanction. See JOHN O. HALEY, *AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX* 57 (1991); FRANK K. UPHAM, *LAW AND SOCIAL CHANGE IN POST-WAR JAPAN* 67-9 (1987). The extremism of didactic conciliation is no longer present today, but the inquiry into the conduct of the plaintiff has taken root. This inquiry has fostered the development of legal doctrines which facilitate findings of contributory negligence: accepted theory is that the judge need not apply the same standard vis-a-vis the plaintiff as against the defendant. Thus, the plaintiff need not be as blameworthy as the defendant in order for there to be a set-off for contributory negligence. It is sufficient to reduce compensation where the plaintiff has been careless based on a conception of fairness. See Higuchi, *supra*, at 115.

### C. THE DUTY NOT TO SOLICIT UNSUITABLE TRANSACTIONS

There is a general consensus among Japanese scholars regarding the definition of the suitability principle (*tekigōsei no gensoku*). The suitability principle is a distinct duty to “inquire after the customer’s investment goals and financial needs. Among the securities transactions investigated, solicitation of only those which the broker believes to accord with such goals and needs is permitted.”<sup>212</sup> As discussed earlier, the public law imposes a duty on brokers to solicit only suitable transactions based on SEL Section 43, and the JSDA’s Rules of Fair Practice, as well as earlier ordinances and circulars.<sup>213</sup> As a result, the cases almost uniformly set out a duty of care that includes a component based on the suitability doctrine. Nonetheless, a trend similar to that found in the misrepresentation cases is evident in that suitability issues are merged into the duty to explain.

There are two distinct groups of cases: those that apply traditional suitability principles and those that reinterpret suitability issues in terms of the securities companies’ duty to explain. In the former category, many apply a traditional suitability analysis and find no breach of duty. Few cases specifically find a broker liable for recommending an unsuitable transaction. In the latter category, the decisions either focus on the defendant’s explanation and the plaintiff’s understanding, and find no violation of the suitability principle or, in the alternative, find a violation but interpret it as a breach of the duty to explain.

#### 1. Traditional Analysis

Opinions that focus on traditional suitability factors look to the investor’s investment knowledge, experience, investment goals, and financial circumstances, and in light of these factors usually find the securities company not liable for soliciting the transaction in question. A 1988 Tokyo Appellate Court Decision analyzed the suitability of margin transactions recommended to a doctor with substantial resources, who had actively traded for over two years in both his wife’s and his own name, and pursued a course of investment independent of the broker’s recommendations.<sup>214</sup> The plaintiff had received an explanation of the transac-

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212. Morita Akira, *Shōken Kaisha to Kōkyaku to no Kankei*, MINSHO HO ZASSHI Vol. 113, No. 4•5 (1996) 690, 697. See also Shimizu Toshihiko, *Tōshi Kanyū to Fuhōkōi*, HANREI TAIMUZU No. 853 (1994) 23, 32; KAWAMOTO ICHIRŌ & OTAKE YASUNAMI, SHOKEN TORIHIKI HO DOKUHON (DAI 3 HAN) 334 (1998).

213. See *supra* Part I text accompanying note 72.

214. Tokyo App. Ct. Decision, Oct. 20, 1988, KINYŪ SHŌJI HANREI No. 813 (1989) 24.

tions, and "at the very least had gained the knowledge and experience of an average investor."<sup>215</sup> The court found:

[I]t is clear that in light of the appellant's investment goals, financial circumstances and investment experience as determined earlier, the size and frequency of the transactions in question were not conspicuously unsuitable. . . . In addition, the stocks involved in these transactions were blue chips stocks of corporations without problems in their assets, business performance and the like, and they were in accord with the appellant's aforementioned intent.<sup>216</sup>

The court found no violation of the broker's duty of care and dismissed the plaintiff's claim for damages.<sup>217</sup>

A 1995 Osaka District Court decision discussed the suitability of warrant transactions, and emphasized that the investor "held at the least forty million yen in stocks, at the time of the transaction in question concurrently conducted transactions with three securities companies, and had over six years of experience in securities transactions."<sup>218</sup> The plaintiff had previously conducted warrant transactions, which had resulted in both gains and losses, and "intended to invest in high-risk transactions."<sup>219</sup> The court held that the transaction was not "clearly excessive" for the investor, and "it can't be said that solicitation of the warrant transaction in question violated the suitability principle and was unlawful."<sup>220</sup>

In looking at these cases, one finds courts emphasizing factors traditionally considered in determining the suitability of an investment.<sup>221</sup> With the exception of investment trust cases, in-

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215. *Id.* at 27.

216. *Id.*

217. *Id.* at 27-28.

218. Osaka Dist. Ct. Decision, Nov. 9, 1995, HANREI TAIMUZU No. 909 (1996) 197, 204.

219. *Id.*

220. *Id.* (finding no breach of the broker's duty to explain and dismissing the plaintiff's claim). The same reasoning can be found in decisions involving investment trusts. *See, e.g.*, Osaka Dist. Ct. Decision, Nov. 27, 1996, HANREI TAIMUZU No. 944 (1997) 185, 192 (The investor, up until the transaction in question, had no knowledge or experience with investment trusts and in light of her purchase of relatively conservative trusts the court assumed that she had no interest in speculation. However, given the investor's "age, academic background (possession of an assistance nurse's qualification) and occupation, at the very least she possessed the general abilities of the average person." The court found that understanding investment trusts did not require an especially high level of knowledge, and of the plaintiff's 10 million yen in assets only a small portion was invested in the so called 'growth' investment trust with its higher risk and the remainder in the less risky 'stable growth' trust. "Given these circumstances, it can't be said that the plaintiff was unsuitable for stock investment trusts nor that [the broker's] solicitation of investment trusts from the plaintiff violated the suitability principle.").

221. *See also* Osaka Dist. Ct. Decision, Mar. 30, 1994, HANREI TAIMUZU No. 855 (1994) 220 (involving an investor with over 20 years investment experience and a 28

vestors in this category of cases inevitably have significant financial experience, either as independent businessmen, corporate executives, or because they are independently wealthy.<sup>222</sup> Most of the investors are found to have significant investment knowledge and experience, and to have conducted numerous transactions via a number of firms over a long period of time.<sup>223</sup> In addition, courts have found these investors to have substantial resources and the transactions in question to have corresponded to a pattern of independent and aggressive trading.<sup>224</sup> In finding no violation of the suitability principle, the courts are conducting an investigation of factors traditionally emphasized in a suitability inquiry.

A similar analysis finding a securities company liable for recommending an unsuitable transaction is rare. There is only one opinion where a court distinguishes between the suitability principle and the duty to explain and specifically holds a securities company liable for making an unsuitable recommendation. In a 1995 Osaka District Court decision, the plaintiff was a doctor with limited investment experience and no experience with war-

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million yen portfolio who purchased 4 million yen worth of warrants); Niigata Dist. Ct. Decision, Apr. 13, 1995, HANREI TAIMUZU No. 876 (1995) 209 (corporation and representative directors with extensive experience in margin and other high-risk transactions, and aggressive investment goals purchased warrants); Tokyo App. Ct. Decision, May 31, 1995, HANREI TAIMUZU No. 897 (1996) 144 (an investor, though elderly and a farmer by occupation, had over 20 years investment experience and actively managed a 45 million yen portfolio purchased warrants); Osaka Dist. Ct. Decision, Aug. 28, 1995, HANREI TAIMUZU No. 902 (1996) 95 (a "housewife" with approximately 5 years investment experience, managed an approximately 10 million yen portfolio, sought to recoup earlier loses and purchased warrants worth 3.2 million yen); Tokyo Dist. Ct. Decision, Aug. 30, 1995, HANREI TAIMUZU No. 911 (1996) 163 (an investor with significant resources, who regularly conducted margin and other high-risk transactions, invested for short-term profits and earned over 10 million yen in the previous 6 months, purchased warrants); Tokyo App. Ct. Decision, Dec. 20, 1995, HANREI TAIMUZU No. 924 (1997) 231 (a company employee with approximately 20 years of investing experience and a 12 million yen portfolio purchased a warrant where the stock price had fallen below the exercise price); Osaka Dist. Ct. Decision, Nov. 25, 1996, HANREI TAIMUZU No. 940 (1997) 205 (an investor-businessman with 3 years investment experience aggressively managing approximately 33 million yen in assets purchased a 15 million yen warrant); Osaka Dist. Ct. Sakai Branch Decision, May 14, 1997, KINYU•SHOU HANREI No. 1026 (1997) 36 (an investor-businessman with extensive experience in securities transactions purchased a warrant); Maebashi Dist. Ct. Decision, June 9, 1997, HANREI JIHO No. 1645 (1998) 113 (corporate head with over 7 years of investment experience trading at multiple securities companies, with some investments exceeding 100 million yen, purchased a country fund); Tokyo Dist. Ct. Decision, Feb. 23, 1998, KINYU•SHOU HANREI No. 1051 (1998) 49 (an investor with over 20 years experience investing in investment trusts and managing over 25 million yen in assets purchased investment trust).

222. *Id.*

223. *Id.*

224. *Id.*

rants.<sup>225</sup> The court noted that warrants were risky, over-the-counter transactions, and in light of this, "in circumstances where a general investor does not understand warrants, or does not have the necessary understanding to be able to protect their own interests, one must refrain from soliciting transactions or acts which cause a transaction to be concluded."<sup>226</sup> The broker solicited a warrant where the stock price had fallen below the exercise price, and only one year remained before the warrant's expiry.<sup>227</sup> The court distinguished between the broker's duties under the suitability principle and the duty to explain, and held that

when considering the plaintiff's investment experience and degree of knowledge about securities transactions, especially the fact that he had absolutely no knowledge of warrants, the problems relating to this particular warrant, the plaintiff's age and the like, one must find that the broker in soliciting the present warrant transaction from the plaintiff violated the suitability principle.<sup>228</sup>

This case stands apart in distinctly providing that the recommendation of unsuitable transactions operates as an independent basis for incurring liability.

## 2. *Emphasis on the Duty to Explain*

While unsuitable transactions are far from rare, in most cases the courts weave suitability issues into an analysis of the duty to explain. Courts have found the investment unsuitable, but held that there was no violation of the suitability doctrine because the broker explained the risks and the investor understood them, or that the unsuitable recommendation was a violation of the broker's duty to explain.

An example of the former is an Osaka Appellate Court decision that held, "given that the appellants received an explanation from Mr. Kuroda [the broker] and received from Mr. Kuroda the warrant disclosure documents . . . and based on this conducted the transaction knowing the general outline of the risks of warrant transactions, the transaction was not unsuitable for the appellants."<sup>229</sup> In finding the transactions not to be unsuitable, the court emphasized that it was based on disclosure and an explana-

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225. Osaka Dist. Ct. Decision, Feb. 23, 1995, HANREI JIHO No. 1548 (1996) 114, 119.

226. *Id.*

227. *Id.* at 120.

228. *Id.* at 119-20 (finding a further violation of the broker's duty to explain, and awarding damages without set-off for contributory negligence).

229. Osaka App. Ct. Decision, Sept. 13, 1996, HANREI TAIMUZU No. 942 (1997) 191, 195, 196 (finding no breach of the broker's duty to explain and dismissing the plaintiff's claims). See also Tokyo Dist. Ct. Decision, Apr. 28, 1995, HANREI JIHO No. 1564 (1996) 45 (holding corporate representatives had an ability to understand

tion, and the investor understood or could have understood the risks. In other words, the inquiry is not of the transaction's objective suitability or lack thereof, but of the mechanics of the broker's explanation and the plaintiff's understanding.

Other opinions have found suitability problems but no breach of duty. In a 1995 Tokyo District Court decision, an elderly investor indicated to the brokers in charge of her account that she "did not understand difficult things," requested that they purchase safe investments, and "please don't buy stocks."<sup>230</sup> The plaintiff later acquiesced to purchasing warrants.<sup>231</sup> The court found that the investor had previously purchased convertible bonds and sufficiently understood that trading in stocks carried risk, so that "one cannot find that the plaintiff was clearly unsuitable for a foreign currency denominated warrant transaction."<sup>232</sup> The court went on to state:

Even if the plaintiff told the defendant brokers 'no stocks', her conviction was only of such a degree that she would not refuse the transaction if strongly recommended by the broker, and the plaintiff sufficiently understood that stock transactions contained risk. In light of this, it cannot be held that the recommendations of the defendant brokers violated the plaintiff's intent, investment objectives and investment aims.<sup>233</sup>

In the case of an elderly investor with some experience investing in stocks, but no experience with margin or other types of transactions, a later Osaka court similarly found that, "one cannot say with certainty that warrant transactions were suitable" for the investor.<sup>234</sup> However, the transactions in question were a small part of the plaintiff's portfolio, and "if the transaction was conducted based on a sufficient explanation of the structure of warrants and their risks and knowledge that the amount invested could be lost in its entirety, then one cannot go so far as to immediately conclude the transaction is unlawful."<sup>235</sup>

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warrant and margin transactions, transactions were begun after a basic explanation by broker, and finding no violation of the suitability principle).

230. Tokyo Dist. Ct. Decision, Dec. 13, 1995, HANREI TAIMUZU No. 922 (1997) 261, 265.

231. *Id.*

232. *Id.* at 267.

233. *Id.* at 267-68 (finding that the plaintiff was unaware of the risk of warrants becoming worthless, the brokers' explanation of this point was insufficient, and awarding plaintiff damages with a 60% set-off for contributory negligence).

234. Osaka Dist. Ct. Decision, June 28, 1996, HANREI JIHO No. 1593 (1997) 87, 90.

235. *Id.* at 91-3 (finding a breach of the duty to explain and awarding the plaintiff damages with a 30% set-off for contributory negligence).

In examining these cases, one finds that there are suitability problems of varying degrees.<sup>236</sup> The investor's financial circumstances, investment objectives, or experience do not lend themselves to the investments recommended by the brokers, but the courts are consistent in emphasizing the duty to explain and permitting solicitation. So long as the transaction is conducted "based on a sufficient explanation," it is not unsuitable. Even where an elderly investor requests up front that the broker not invest in stocks, if the investor has "sufficient understanding" of the risk of stock transactions, the solicitation itself is not unlawful.

Other cases provide a variation on the same theme. In contrast to the previous cases where there was no finding of unsuitability, these cases specifically find the transaction to be unsuitable, yet hold the broker liable for a violation of the duty to explain. A broker recommended warrants to a representative of a Buddhist temple even though the representative had indicated that the funds were being invested for the temple and to be invested conservatively.<sup>237</sup> A Nagoya Summary Court found the recommendation unsuitable. "A high-risk, high-return product such as the warrant in this case should not originally have been solicited,"<sup>238</sup> but the court went on to state that "if solicited, sufficient explanation is to be given and sufficient understanding to be obtained prior to trading."<sup>239</sup> The defendant's broker was held not to have provided a sufficient explanation and therefore to have breached his duty of care.<sup>240</sup>

A 1994 Tokyo District Court decision similarly found that a broker should not have solicited warrant transactions from a widower with no work experience or knowledge of investing.<sup>241</sup> The court found the plaintiff was unable to fully understand the explanation provided by the defendant brokers and the brokers were clearly aware of this. The court concluded that "in the first place, it must be said that the plaintiff was not a suitable subject

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236. See also Osaka Dist. Ct. Decision, Sept. 14, 1994, HANREI TAIMUZU No. 875 (1995) 171, 185-86 (finding "an element of unreasonableness" where a broker solicited the purchase of a warrant that he knew would require a loan and double the amount the plaintiff indicated he had available to invest, the court held that given the investor's interests and financial circumstances "based on a sufficient explanation about warrants and if the investment is made based on an understanding of this explanation, circumstances do not support going so far as to find a suitability violation").

237. Nagoya Summary Court Decision, June 30, 1993, KINYŪ•SHŌJI HANREI No. 943 (1994) 38.

238. *Id.* at 41.

239. *Id.*

240. *Id.* at 41-2 (holding defendants liable for 80% of the temple's damages).

241. Tokyo Dist. Ct. Decision, Sept. 8, 1994, HANREI JIHO No. 1540 (1995) 71.

for solicitation of speculative securities transactions. Thus, the defendant should have, from the first, avoided soliciting warrant transactions."<sup>242</sup> The court, however, went on to state,

[I]n the event a securities company solicits high-risk transactions from unsuitable customers such as this, it is insufficient simply to mention the risk of the transaction and obtain the customer's understanding about this point. There is a duty to explain clearly and in detail the worst possible scenario, obtain the customer's understanding of this, and confirm their intention to conduct the transaction.<sup>243</sup>

The court held that the defendant breached this duty to explain.<sup>244</sup>

There is an inextricable association between suitability issues and the broker's duty to explain in these cases.<sup>245</sup> The vast

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242. *Id.* at 74.

243. *Id.* at 74-75.

244. *Id.* This case is said to be indicative of a sliding scale used by the courts in interpreting the duty to explain. In cases where the transactions are found unsuitable, the degree of explanation required borders on that required of a trustee or fiduciary. See Shiomi Yoshio, *Toshi Torihiki to Minpō Riron (I)—Shōken Toshi wo Chūshin Toshite*, *MINSHŌ HŌ ZASSHI* Vol. 117 No. 8 (1998) 807, 817. Whether or not this case is indicative of a sliding scale, clearly unsuitable recommendations are repeatedly addressed in terms of the defendant's duty to explain the transaction. See Tokyo Dist. Ct. Decision, Nov. 11, 1997, *KINYŪ•SHŌJI HANREI* No. 1031 (1998) 37 (Plaintiff was uneducated and had a history of relying on brokers' recommendations to conservatively invest in stocks. The defendant's broker recommended selling two such stocks and purchasing a warrant worth twice the sum of any single investment she had made in the preceding ten years. The court found "one cannot say that the plaintiff was one for whom purchasing warrants was sufficiently suitable, and when recommending the purchase of a warrant to such an investor, the securities company's broker needs to carefully discern, having sufficiently explained that warrant transactions are high-risk, high-return. . . whether the investor has independently formed an intent to buy." The court went on to find "the defendant's explanation to the plaintiff . . . was insufficient and inappropriate. Therefore, the defendant's recommendations to the plaintiff of the purchase of the warrant was unsuited to the plaintiff's investment characteristics and unlawful.").

245. Suitability issues in the U.S. provide a point of comparison. While the Japanese SEL specifically addresses unsuitable recommendations, courts are reluctant to find a transaction unsuitable and when they do so it is interpreted as a breach of the securities company's duty to explain. In the U.S., a suitability rule is absent from federal securities laws, but judicial interpretation has created a limited suitability requirement under Section 10(b) of the 1934 Act (15 U.S.C. § 78j(b)) and SEC Rule 10b-5 (17 C.F.R. § 240.10b-5). In doing so, U.S. courts have imposed liability for an unsuitable transaction based on two distinguishable theories: that the recommendation contains a misrepresentation or omission and is fraudulent, or that the recommendation itself is unsuitable and acts as a fraudulent device. See, e.g., *Clark v. John Lamula Inv., Inc.*, 583 F.2d 594, 600-01 (2nd Cir. 1978) (finding a violation of Rule 10b-5 where defendant intentionally recommended unsuitable debentures); *Clark v. Kidder, Peabody & Co., Inc.*, 636 F. Supp. 195, 198-99 (S.D.N.Y. 1986) (upholding cause of action for knowing recommendation of unsuitable security, but dismissing count alleging failure to explain security); *O'Connor v. R. F. Lafferty & Co., Inc.*, 985 F.2d 893, 897-98 (10th Cir. 1992) (acknowledging "[u]nsuitability claims can be analyzed as omission cases or fraudulent practice cases," and finding a suitability

majority of cases recognize the existence of an independent duty of care based on the suitability principle, but in their application they do not. In contrast to the courts that apply traditional suitability factors and conclude the recommendation was not unsuitable, there are few decisions that explicitly find a violation of the suitability principle and impose liability independent of a breach of the duty to explain.<sup>246</sup> In the more egregious cases, courts ultimately premise liability on a breach of the duty to explain and hold the defendants liable for a portion of the plaintiff's damages. In doing so, they tacitly condone unsuitable recommendations so long as there is a suitable explanation.<sup>247</sup>

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claim based on fraud by conduct analogous to a churning claim); *Brown v. E. F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2nd Cir. 1993) (requiring plaintiffs to prove "that, with scienter, the defendant made material misrepresentations . . . relating to the suitability of the securities"). The Japanese courts' unwillingness to address suitability issues independently of the duty to explain is in effect a rejection of the possibility that the recommendation itself can act as a fraudulent device.

246. The judicial development of a duty to explain and neglect of the suitability provisions raises the question why. There are no definite answers, but the judicial opinions and literature suggest some possibilities. In 1988, Japan joined the International Organization of Securities Commissions (IOSCO), which later adopted norms for securities dealers including good faith and suitability provisions in 1990. As part of an effort to comply, Japan amended the SEL in 1992 adding a good faith provision, currently Section 33, and a suitability rule, currently Section 43. See KAWAMOTO ICHIROU AND OOTAKE YASUNAMI, *SHOUKEN TORIHIKI DOKUHON (DAI 4 HAN)* 356 (2000). The suitability section of the SEL is thus a foreign transplant, inspired by an effort to conform to international norms, which has never taken root. Its presence is duly acknowledged, but its application fundamentally conflicts with the notion of self-responsibility, or *jiko sekinin*. See *supra* note 172. A suitability rule shifts the burden from the investor to the broker in making or eliminating inappropriate choices. In contrast, the duty to explain conceptually places ultimate responsibility upon the investor and is a foundation for the investor's "self-responsibility." Where a holding that a recommendation was unsuitable absolves the investor and is inconsistent with a later finding of contributory negligence, the duty to explain continues to require due diligence on the part of the investor and permits a set-off for contributory negligence as Japanese courts prefer. In practice, of course, there are times when a recommendation is objectively unsuitable or unreasonable, or the broker acted as a fiduciary and more stringent duties are appropriate. It is in these situations that courts have expanded the duty to explain, perhaps beyond its conceptual bounds. See generally Shiomi Yoshio, *Tōshi Torihikū to Minpō Riron* (4): *Shōken Tōshi o Chūsin Toshūte*, *MINSHO HŌ ZASSHI* Vol. 118 No. 3 (1998) 50, 51-7.

247. Scholarly opinion is divided as to what the legal doctrine should be. There are those that posit that a violation of the suitability doctrine presupposes a violation of the duty to explain, and emphasize the duty to explain as a principle component in implementing "the principle of self-responsibility." The focus is on gaining the investor's understanding and ability to make and be responsible for independent decisions. See Watanabe Masanori, *Waranto Torihiki ni Okeru Tōshi Kanyū to Tōshūsha Hogo*, *HANREI TIMUZU* No. 870 (1995) 12, 19; Matsuhara Masahi, *Tōshi Kanyū ni Okeru Jiko Sekinin Gensoku•Tekigōsei Gensoku•Setsumeji Gimū—Waranto Soshō wo Keiki Toshūte*, *SHIMANE DAIGAKU HŌGAKU RONSHŪ* Vol. 38 No. 4 (1995) 37, 65. A second theory posits a correlation between the suitability principle and the duty to explain—a relatively unsuitable transaction will require a relatively more detailed explanation, as well as the inverse. See Shimizu, *supra* note 182,

#### D. THE DUTY TO EXPLAIN

Notwithstanding reliance by the judiciary on the duty to explain, there is no duty to explain in the SEL. The SEL and related regulations prohibit specific kinds of misleading conduct and the recommendation of unsuitable transactions.<sup>248</sup> The regulations also require written disclosure in certain kinds of transactions, but they do not specifically require the securities company or broker explain the transaction.<sup>249</sup> Nonetheless, the courts have expanded the duty to explain so that it encompasses virtually the entire gamut of issues surrounding brokers' actions and their duty of care. As a result, discussion of the duty both in court decisions and scholarship is voluminous and divided, with a wide range of interpretations of its scope and breadth.

##### 1. *From Disclosure to the Duty to Explain*

A small minority of decisions, many of them early ones, limit the scope of the duty to explain to little more than the written disclosure required by public law. A 1993 Tokyo District Court held that where the defendant provided the necessary disclosure documents for warrant transactions and obtained the required written confirmation of intent from the investors, nothing more was required.<sup>250</sup> Liability was denied because "it cannot be said that the defendant or [defendant's employee] obstructed formation of the plaintiffs' accurate understanding of the risks of warrants by providing false information or conclusive evaluations."<sup>251</sup>

In a dispute over several investment trust transactions, a later Kobe District Court decision found no duty to explain, holding:

[U]nless it can be held there were special circumstances where there was false advertising, notice, or solicitation (for example, the provision of untrue information such as that the principal was guaranteed or mistaken information about what the trust

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at 82, 96. Finally, a third group of scholars argue that the suitability doctrine should be applied independently, and regardless of the sufficiency of the explanation the solicitation of an unsuitable transaction is unlawful. See Yamashita Tomonobu, *Shōken Tōshi no Kanyū to Setsumei Gimu—Waranto no Tōshi Kanyū wo Chūshin to Shite*, KINYŪ HŌMU JIJŌ No. 1407 (1995) 27, 36 nt. 9; Miki Toshihiro et al., *Shōken Tōshi Kanyū to Minji Teki Ihōsei—Gaikadate Waranto Torihiki wo Megutte—*, HANREI TAIMUZU No. 875 (1995) 28, 32.

248. See *supra* Part I.A.2.

249. *Id.*

250. Tokyo Dist. Ct. Decision, May 12, 1993, HANREI JIHŌ No. 1466 (1993) 105.

251. *Id.* at 110.

was invested in). . . as a matter of course the customer cannot demand compensation for losses.<sup>252</sup>

These opinions find the provision of the disclosure documents to be conclusive, and make no mention of a distinct duty to explain to the investor the nature of the transaction. However, a vast majority of courts have come to adopt a position requiring more than simple disclosure or provision of information.<sup>253</sup> "A securities company and broker, when soliciting a securities transaction, have a duty vis-à-vis a general investor to clearly explain the structure and risks of the said transaction."<sup>254</sup>

Where a broker did not explain the risk to principal or provide a prospectus to an elderly investor when recommending a number of investment trusts, an Osaka District Court went be-

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252. Kobe Dist. Ct. Decision, July 18, 1996, HANREI TAIMUZU No. 927 (1997) 176, 178. See also Tokyo Dist. Ct. Decision, Aug. 30, 1995, HANREI TAIMUZU No. 911 (1996) 163, 167 (The court found no duty to explain: disclosure documents were provided and written confirmation received from an experienced investor. The investor, "based on these documents, could have easily understood the nature of the warrant transactions he was undertaking, moreover, the plaintiff did have such an understanding."); Osaka App. Ct. Decision, Sept. 13, 1996, HANREI TAIMUZU No. 942 (1997) 191, 195-96 (finding the fact that warrant transactions are over-the-counter transactions with the securities company acting as a principal is stated in the disclosure documents, and there is no separate duty to explain the issues relating to price formation).

253. Courts have gone beyond risk disclosure as commonly defined under federal securities law in the U.S. The basic premise in U.S. securities law is full disclosure or provision of information, and not an explanation of that information in a manner tailored to the individual characteristics of the investor. The purpose of the 1934 Act was to substitute "a philosophy of full disclosure for the philosophy of caveat emptor." See *Santa Fe Indus. v. Green*, 430 U.S. 462, 477 (1977); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972). In its application to the secondary market and issues of fraud, "[t]he law is clear that a broker owes a duty of full and fair disclosure to a securities investor." *Thompson v. Smith Barney, Harris Upham & Co., Inc.*, 709 F.2d 1413, 1418 (11th Cir. 1983). The elements of a Section 10(b) and Rule 10b-5 action begin with a "misstatement or omission" rather than a failure to explain information. See, e.g., *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1046 (11th Cir. 1987); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989); *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289 (3rd Cir. 1991). But see, *Vucinich v. Paine Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 460 (9th Cir. 1986).

254. Osaka App. Ct. Decision, May 30, 1997, KINYO SHOJI HANREI No. 1030 (1997) 19, 23. See also Tokyo Dist. Ct. Decision, Apr. 28, 1995, HANREI JIHO No. 1564 (1996) 52, 58 ("when soliciting margin transactions, a good faith duty arises for the securities company or its employee to explain the previously mentioned risks according to the customer's experience, knowledge and the like"); Tokyo Dist. Ct. Decision, June 30, 1994, HANREI JIHO No. 1532 (1995) 79, 82 (Holding options "are not easily understood by the general investor. . . [and the broker], without showing the disclosure documents, did no more than simply show past examples and verbally explain in general terms about price movements and the like. The content of this explanation was insufficient.").

yond simply requiring the timely delivery of the prospectus by insisting a concrete explanation accompany the documents:

It is necessary to go beyond a perfunctory, abstract explanation of such things as what type of trust the said investment trust is, and provide information sufficient for the investor to make an accurate decision regarding the appropriateness of the investment or make it clear the investor individually should acquire such information. . . . One should explain about essential factors concerning the character of the said investment trust and its risks in such a manner that they can be sufficiently understood.<sup>255</sup>

The duty to concretely explain the transaction and its characteristics to an inexperienced investor is made abundantly clear in another investment trust opinion:

It is difficult to say that the customer simply having received the brochure was able to understand the generalities of investment trusts, their specific characteristics, the so called risk to principal, and the like. . . . [Furthermore] for one with no experience in securities transactions, it is not possible to immediately understand the structure of an investment trust in stocks based on the information discussed previously that is found in the prospectus, the broker's explanation of this information is indispensable.<sup>256</sup>

This duty to explain is not merely limited to the elderly or the uneducated. In a case involving a sophisticated investor with extensive assets and trading experience, an Osaka District Court decision held there is "a duty to provide information to the investor sufficient for the formation of an accurate understanding of the risk, structure of the product, and the like, based on the investor's occupation, age, financial circumstances, investment

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255. Osaka Dist. Ct. Decision, June 13, 1995, HANREI TAIMUZU No. 890 (1995) 172, 182-183 (finding the defendant at most explained the trusts in question invested in stocks and gave estimates of the trusts returns, and holding the defendant violated his duty to explain and was liable for 20% of the investor's losses); *see also* Miyazaki Dist. Ct., Miyakonojō Branch, Decision Mar. 25, 1998, KINYŪ HŌMU JIJŌ No. 1516 (1998) 47, 53 (The explanation "should go beyond a superficial, abstract explanation of the type of the said investment trust and whether the specific investment includes stocks. It is necessary to provide information sufficient for the general investor to be able to make an accurate decision about the appropriateness of the investment. . . . [the broker] had a duty to explain about this point and provide an appropriate explanation about the risk of loss of principal." The defendant spent only 2-3 minutes explaining things by phone, with no reference to structure or risk, failed to provide a prospectus, and thus violated his duty to explain and was liable for 60% of the plaintiff's damages.).

256. Osaka Dist. Ct. Decision, Nov. 27, 1996, HANREI TAIMUZU No. 944 (1997) 185, 193 (finding the broker provided no explanation or disclosure documents, violated the duty to explain, and was liable for damages with a 60% set-off for the plaintiff's contributory negligence).

objectives, investment experience, and the like.”<sup>257</sup> The parameters of the duty are adjusted to the characteristics of the investor, and the complexity and risk of the transaction. The requirements are “decided depending on the interrelationship between the degree of complexity of the structure of the security, the magnitude of risk assumed in the transaction, its degree of familiarity, and the investor’s experience, ability to understand and the like.”<sup>258</sup>

The courts and scholars have struggled with the scope of such a duty. Quite apart from a simple delineation between sophisticated and unsophisticated investors, complex and simple transactions, risky and conservative investments, the courts have split between those employing an objective standard and those employing a subjective standard.

## 2. *The Duty to Explain—An Objective Standard*

Some courts apply an objective standard, finding that an investor with a given amount of knowledge or experience could have or should have understood the risks. A 1995 Osaka District Court found the defendant’s explanation “was sufficient for a correct recognition of the structure of warrants, the risk, and other factors” and granted judgment for the defendants.<sup>259</sup> A decision handed down by a Tokyo District Court on the same day similarly found no violation of the duty to explain. In light of the investor’s rich trading experience in stocks and convertible bonds and based on the broker’s explanation, the investor “could have sufficiently understood” that warrants move in tandem with the price of the underlying stock but are a more volatile high-risk, high-return product.<sup>260</sup> Likewise, a 1998 Osaka District Court decision held that in light of the investor’s age, occupation, investing experience, and knowledge, the broker’s explanation at the time of his recommendation, when combined with the disclo-

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257. Osaka Dist. Ct. Decision, Nov. 24, 1995, HANREI TAIMUZU No. 909 (1996) 193, 197. See also Osaka Dist. Ct. Decision, Nov. 25, 1996, HANREI TAIMUZU No. 940 (1997) 205, 212 (“There is a good-faith duty to explain the special characteristics of foreign currency denominated warrants and risks to a degree sufficient for customers to accurately understand them.”).

258. Miyazaki Dist. Ct., Miyakonojō Branch, Decision Mar. 25, 1998, KINYŌ HŌMU JIJŌ No. 1516 (1998) 47, 53. See also Tokyo Dist. Ct. Decision, Feb. 15, 1994, HANREI TAIMUZU No. 844 (1994) 213, 218-19 (“Assuming the plaintiff’s experience and knowledge as previously described, if there is an explanation of the most significant differences between stock index option transactions and stock transactions (non-margin and margin), that an exercise period exists and when this date passes the option becomes worthless, it is reasonable to conclude that essentially the duty to explain has been satisfied.”).

259. Osaka Dist. Ct. Decision, Nov. 24, 1995 HANREI TAIMUZU No. 909 (1996) 193, 197.

260. Tokyo Dist. Ct. Decision, Nov. 24, 1995, HANREI TAIMUZU No. 923 (1997) 238, 243.

sure documents, was “sufficient to understand the basic features and risks of the warrant in question.”<sup>261</sup>

The court in each of these opinions focuses, not on the broker gaining the understanding of the specific investor, but on the broker’s explanation and the investor’s sophistication, and concludes that it was “sufficient” for the investor to have understood, or that the investor “could have sufficiently understood” the risks. These courts in effect apply a standard of a reasonable investor under similar circumstances to find the plaintiff should have understood the risks and, thus, is responsible for any adverse outcome.

Other cases show brokers failing, rather than meeting, an objective standard. In one case, a broker recommended warrant transactions to a stay-at-home mother without significant investing or work experience.<sup>262</sup> The broker had a “duty of care to provide information sufficient for the investor to accurately understand the risks,” but nonetheless “simply stated that warrants were high-risk, high-return and mentioned in abstract terms that there was a time limit for exercising them.”<sup>263</sup> The broker provided the disclosure materials and obtained the plaintiff’s written confirmation of intent after the transaction, and “did not even point out the relevant portions of the explanatory materials. Thus, it must be said the broker breached his duty.”<sup>264</sup>

In another instance, a broker recommended warrants to an investor with no prior investment experience, spent four or five minutes explaining them, and provided the disclosure documents later.<sup>265</sup> The broker’s explanation mentioned little more than the fact that warrants have returns several times those of stocks, are “new hit products,” and have no transaction fees.<sup>266</sup> The court found the broker conducted each warrant transaction without properly explaining it, the circumstances did not permit an abbreviated explanation, and he had breached his duty of care.<sup>267</sup>

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261. Osaka Dist. Ct. Decision, Nov. 25, 1996, HANREI TAIMUZU No. 940 (1997) 205, 213.

262. Osaka Dist. Ct. Decision, Feb. 10, 1994, HANREI TAIMUZU No. 841 (1994) 276.

263. *Id.* at 281.

264. *Id.* at 282 (finding the defendant liable with a 35% set-off for the negligence of the plaintiff).

265. Osaka App. Ct. Decision, Apr. 20, 1995, HANREI TAIMUZU No. 885 (1995) 207.

266. *Id.* at 215.

267. *Id.* (setting off 20% of the award because of the plaintiff’s contributory negligence). *See also* Tokyo App. Ct. Decision, Mar. 18, 1996, HANREI TAIMUZU No. 923 (1997) 146, 149 (A broker explained to an investor, with no prior experience with warrants, little more than that warrants move in conjunction with their underlying stocks but are more volatile, and a market rebound was expected. The investor signed the confirmation and purchase agreements but did not receive the disclosure

In these cases the courts focus on what is perceived to be a clearly insufficient explanation. There is a standard duty requiring a broker to sufficiently explain the nature and risks of the transaction as well as provide the required disclosure documents. Where the broker simply states that warrants are volatile or are a "hit product," and does not provide the required disclosure documents at the time of this explanation, the broker's conduct is objectively deficient and breaches his or her duty of care.

### 3. *The Duty to Explain—A Subjective Standard*

In contrast to these opinions, there are courts that apply a subjective standard, taking care to find that the investor in question, not just someone of like situation, understood the risks.

A 1995 Tokyo Appellate Court decision noted the plaintiff's age, her activities as an entrepreneur, extensive experience in trading, and her prior losses in the stock market, and found that she "knew well the risks of stock transactions, and understood that warrants were more speculative than stocks and their risks greater."<sup>268</sup> Another Tokyo Appellate Court decision determined the investor had significant experience, had conducted warrant transactions in the past, and on this occasion "received an explanation about warrants, and purchased them based on a sufficient understanding of their meaning."<sup>269</sup> In each of these decisions, the courts explicitly found the plaintiff understood the risks and basic structure of the transaction in question.

Perhaps of greater significance are numerous opinions which hold that despite detailed explanations by the broker, the investor did not subjectively understand the risks and because of that the broker was liable.

In the 1994 Osaka case discussed earlier, the court found no liability for the broker's recommendation of an unsuitable warrant transaction to a successful businessman but did find a breach

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documents until after the purchase. The defendant breached his "good-faith duty of care in concluding a contract to sufficiently explain to the appellant about the high risks inherent in the foreign currency denominated warrant discussed earlier," and was liable for damages with a 60% set-off for the plaintiff's contributory negligence.).

268. Tokyo App. Ct. Decision, Mar. 30, 1995, HANREI TAIMUZU No. 885 (1995) 216, 221.

269. Tokyo App. Ct. Decision, Dec. 26, 1996, KINYŪ•SHŌJI HANREI No. 1022 (1997) 26, 32. *See also* Osaka Dist. Ct. Decision, Nov. 9, 1995, HANREI TAIMUZU No. 909 (1996) 197, 204 (The court held defendant not liable after providing plaintiff investor with written explanatory materials and explaining about warrants. The plaintiff "having read through the materials could have understood about the structure of warrant transactions and their risks. . . [and after the first transaction] was sufficiently aware that warrant prices were volatile and great risk accompanied this.").

of the duty to explain.<sup>270</sup> The broker spent approximately 25 minutes explaining in detail the structure and risks of warrant transactions.<sup>271</sup> Prior to payment, the broker provided the disclosure documents and explained once again the structure of the transaction and risks.<sup>272</sup> The investor responded by telling the broker, "I don't understand it, but anyway I trust you so let's do it."<sup>273</sup> The court held that a securities company has a duty to "explain the transaction so investors are able to obtain enough information so they can make an accurate decision whether or not to invest."<sup>274</sup> Even when the investor has substantial resources and economic experience, the court found "at the very least the principle factors relating to the special characteristics of warrants and their risk should be explained so they can be sufficiently understood by the investor."<sup>275</sup> The broker had breached his duty to explain.<sup>276</sup>

In the 1995 Tokyo District Court decision previously mentioned, the plaintiff specifically requested only safe investments with no stocks transactions but was sold warrants.<sup>277</sup> The defendant's broker in recommending the warrant transactions, explained them, provided the requisite disclosure documents, and obtained the plaintiff's written confirmation of intent. In soliciting a later warrant transaction, one of the defendant's brokers also "showed [the investor] the disclosure document, and read aloud to her about the risk of warrants and the like."<sup>278</sup>

The court held, "there is a duty to explain the basic substance" of the transaction,<sup>279</sup> and found that "because it is clear the plaintiff conducted the present warrant transaction not recognizing that there was a risk warrants can become absolutely worthless, from this point it can be presumed that in the course of [the defendant brokers'] Mr. Miyazawa and Mr. Kogura's explanations to the plaintiff their explanation about the risk of the

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270. Osaka Dist. Ct. Decision, Sept. 14, 1994, HANREI TAIMUZU No. 875 (1995) 171. See *supra* text accompanying note 236.

271. *Id.* at 178.

272. *Id.*

273. *Id.*

274. *Id.* at 184.

275. *Id.*

276. *Id.* at 185-86 (noting the plaintiff's limited investment experience, the broker's history of acting as an adviser, and the questionable suitability of the transaction, but awarding only 20% of the plaintiff's total damages).

277. Tokyo Dist. Ct. Decision, Dec. 13, 1995, HANREI TAIMUZU No. 922 (1997) 261. See *supra* text accompanying note 230.

278. *Id.*

279. *Id.* at 267.

warrant becoming absolutely worthless was insufficient.”<sup>280</sup> The defendants therefore breached their duty to explain.<sup>281</sup>

Even without the use of a presumption, in these cases the investor’s understanding, or more accurately lack of understanding, is determinative. A further example is that of a broker recommending a series of warrant transactions in a down market to the president of a corporation.<sup>282</sup> The court held the broker “has a duty to make the nature of warrants and their risks sufficiently understood.”<sup>283</sup> The court found the defendant’s explanation prior to the first transaction insufficient, and the second explanation “was deficient as a general explanation and did not explain about the stock price falling below the warrant’s exercise price. . . . Recognition of the special characteristics of warrants was not obtained. Solicitation such as [the broker] Mr. Nanjo’s violates the duty to explain required in securities transactions.”<sup>284</sup>

In these cases, the broker’s explanation is held to be insufficient because it fails to gain the concrete understanding of the investor in question. The plaintiff’s understanding is to be “obtained,” or the explanation can be “presumed” deficient where the plaintiff did not understand the transaction. Whether the investor is uneducated and elderly or a successful businessman, where there is reliance by the investor on questionable recommendations or objectively unsuitable recommendations from the broker, these courts impose a high standard of care. They hold the securities company strictly liable for ensuring the investor conducts the transaction knowing the risks, and lessen the burden by finding the plaintiff contributorily negligent and subjecting the award to a set-off.<sup>285</sup>

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280. *Id.*

281. *Id.* (holding defendant liable for the plaintiff’s damages with a set-off of 60% for the plaintiff’s contributory negligence).

282. Sendai App. Ct. Decision, Oct. 14, 1996, KINYŪ SHOJI HANREI No. 1009 (1997) 18.

283. *Id.* at 21.

284. *Id.* at 22 (holding defendant securities company liable for the plaintiff’s damages with a 50% set-off for contributory negligence); see also Tokyo App. Ct. Decision, Nov. 27, 1996, HANREI TAIMUZU No. 926 (1997) 265, 270 (finding the risk was explained to an educated investor, but holding the defendant “violated his good-faith duty of care” to explain in a manner which enabled the investor “to independently decide whether or not to conduct the present warrant transaction based on the appellant’s accurate understanding of an explanation and information provided,” plaintiff’s damages were set-off by 30% for contributory negligence), *aff’d on appeal*, Sup. Ct. Decision June 11, 1998, ZENKOKU SHONKEN MONDAI KENKYŪKAI HEN, SHŌKEN TORIHIKI HIGAI HANREI SEREKUTO No. 8 (1998) 325.

285. The set-off for the plaintiff’s contributory negligence in breach of duty to explain cases is similar to that found in the misrepresentation cases discussed *supra* note 211. Courts find the plaintiffs’ reliance on their brokers unreasonable, or in the case of investment trusts that the plaintiffs should be held liable for knowing that

#### 4. *Beyond the Duty to Explain*

Some courts, however, have required more: in some cases requiring the broker to confirm the investor's concrete understanding of the nature and risks of the transaction; in other cases imposing on the broker an ongoing duty to advise after the purchase; and, in a few decisions, imposing a duty on the broker to actively dissuade an investor from the transaction.

In the 1994 Tokyo District Court decision *supra*, where warrant transactions were solicited from a widower with no investment experience, the court required confirmation of the plaintiff's understanding. When soliciting an unsuitable transaction, "the broker must explain in clear and detailed terms what would happen in the worst case scenario, and having sufficiently made this understood, there is a duty to confirm that based on this understanding the customer is still interested in the transaction."<sup>286</sup> The court found the defendant "provided a general, conventional explanation about warrants, and referred not only to their merits, but also the risk," and noted, "the risks are explained in easy to understand terms in the disclosure documents."<sup>287</sup> However, "this information was not specifically explained by the broker, nor was the aforementioned risk called to the investor's attention, and their understanding con-

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which is, in the court's determination, "common knowledge." See Osaka App. Ct. Decision Apr. 20, 1995, HANREI TAIMUZU No. 885 (1995) 207, 215 (Plaintiff received written explanatory materials and "should have made an effort to gain an accurate understanding of the nature of investing in warrants. . . using these explanatory materials as an aid, reading securities investment related magazines and books, receiving detailed explanations from the securities company, and the like." The damages were subject to a 20% set-off for contributory negligence.); Osaka Dist. Ct. Decision, Sept. 14, 1994, HANREI TAIMUZU No. 875 (1995) 171, 185-186 (Plaintiff "made no effort to know the details," but "relied on [the broker] conducting discretionary transactions" despite the plaintiff having "sufficient sophistication to be expected to understand." The court reduced the award by 80%.); Tokyo Dist. Ct. Decision, Dec. 13, 1995, HANREI TAIMUZU No. 922 (1997) 261, 267-68 (The "explanatory materials for the warrant were provided, and if the plaintiff had even read these materials . . . could have understood that there were risks . . . the plaintiff accepted the defendant brokers' one-sided solicitation and basically entrusted the transactions to them." The damages were subject to a 60% set-off for contributory negligence.); Tokyo App. Ct. Decision, Mar. 18, 1996, HANREI TAIMUZU No. 923 (1997) 146, 149 ("[I]t is common knowledge that with many of the products handled by securities companies the principle is not guaranteed." The plaintiff readily relied on the broker's solicitation in purchasing the investment trusts, and her damages were set off by 60%.); Osaka Dist. Ct. Decision, Nov. 27, 1996, HANREI TAIMUZU No. 944 (1997) 185, 193-194 ("[I]t is primarily a matter of common sense" that risk accompanies investment trusts, and the plaintiff had sufficient opportunity to read the material provided and request any necessary explanation, and thus was subject to a 60% set-off.).

286. Tokyo Dist. Ct. Decision, Sept. 8, 1994, HANREI JIHŌ No. 1540 (1995) 71, 74-75. See *supra* text accompanying note 241.

287. *Id.* at 75.

firmed.”<sup>288</sup> The broker was “at the very least negligent” in his recommendation of the transaction.<sup>289</sup>

In a 1997 Sendai Appellate Court case, the broker continued to solicit warrant transactions without pointing out the mounting losses the investor was sustaining. The court found that because the investor was simply following the broker’s recommendation, the broker not only had a duty to explain the initial transaction but also an ongoing duty to re-explain when appropriate, obtain the investor’s understanding, and confirm the investor’s intent to conduct the transaction.<sup>290</sup> The defendant “more or less explained about warrants,” but provided neither a concrete explanation based on the disclosure documents, nor discussed the investor’s mounting losses.<sup>291</sup> In such a case, “the broker has a duty to explain once again the special characteristics of warrants, gain the investor’s understanding, as well as confirm that the investor nonetheless intends to conduct the transaction.”<sup>292</sup> Because the defendant “did no more than conduct a general explanation prior to beginning the warrant transactions, he violated the necessary duty of care (the duty to explain) in both soliciting warrant transactions and thereafter in continuing them.”<sup>293</sup>

While some decisions have denied the plaintiff’s claim of a breach of the duty to confirm the investor’s understanding, often without disputing that such a duty may exist,<sup>294</sup> those courts that impose such a duty adopt a subjective standard. They condition the transaction on an explanation tailored to gaining the understanding of that individual and confirmation that the individual does in fact understand.

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288. *Id.*

289. *Id.* (finding plaintiff also negligent and reducing her damages by approximately 50%)

290. Sendai App. Ct. Decision, Oct. 29, 1997, HANREI JIHŌ No. 1647 (1998) 115.

291. *Id.* at 118, 120.

292. *Id.* at 121.

293. *Id.* at 122 (setting off 30% of the award for contributory negligence); *See also* Tokyo Dist. Ct. Decision, Oct. 26, 1995, HANREI TAIMUZU No. 915 (1996) 223, 227 (finding that defendant “did not explain the risks of warrant transactions, and concluded the transaction without confirming whether or not the plaintiff sufficiently understood about warrants”).

294. Niigata Dist. Ct. Decision, Apr. 13, 1995, HANREI TAIMUZU No. 876 (1995) 209, 216 (finding a detailed explanation of the transactions was given to a sophisticated investor and no “violation of the duty to explain and confirm”); Nagoya App. Ct. Decision, Oct. 2, 1996, HANREI JIHŌ No. 1594 (1997) 96, 101, (finding the duty to explain “is not to be determined uniformly,” but concretely set based on the investor’s experience, and holding the explanation in the present case sufficient “even if [the broker] did not comprehensively and in detail explain the transaction while checking at each step if the investor was understanding the explanation”).

The same can be said of cases discussing a broker's ongoing duty to advise. Some courts have summarily denied the existence of an ongoing duty to advise, and others have simply found no breach of this duty.<sup>295</sup> Those that do impose an affirmative duty to provide information and advise after the transaction, require information tailored to the individual circumstances of the investor.<sup>296</sup>

An example is found in a 1996 Hiroshima Appellate Court decision, which held the broker had an ongoing duty of care to prevent an unsophisticated investor from losing an opportunity to sell the investment.<sup>297</sup> The court determined that "even after the value of the Fujitsu warrant dropped suddenly, the plaintiff did not receive accurate information from [the broker] and the other employees of the appellee, and with the price not recovering lost the opportunity to sell the warrant and it expired worthless. Therefore the solicitation of the appellee's employee violated the duty to explain and was illegal."<sup>298</sup> The Court premised liability on both a failure to explain the initial transaction and a failure to provide "appropriate advice" after the sale.<sup>299</sup>

The Sakai branch of the Osaka District Court was equally explicit in its imposition of an ongoing duty of care.<sup>300</sup> In this case, the plaintiff was a sophisticated investor, with experience on a corporation's board of directors and in trading stocks, who nonetheless relied on his brokers.<sup>301</sup> The court found that at the

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295. Osaka App. Ct. Decision, Sept. 12, 1995, HANREI JIHO No. 1566 (1996) 44, 46 ("There is no basis for burdening any securities company with the duty to provide the customer information regarding the purchased product's price and the like, or advise when it is in play."); Osaka Dist. Ct. Decision, Nov. 25, 1996, HANREI TAIMUZU No. 940 (1997) 205, 213 (defendant reported to the plaintiff "on a number of occasions market conditions. . . [there was] not sufficient evidence to find the defendant deliberately provided wrong information or advice," and there was no duty beyond that).

296. Osaka Dist. Ct. Decision, Nov. 9, 1995, HANREI TAIMUZU No. 909 (1996) 197, 204 (finding that "because after the transaction in question, [the broker] reported to the plaintiff the price of the warrants, in this regard there was no violation of the duty to provide information"); Tokyo Dist. Ct. Decision, Jan. 17, 1995, HANREI TAIMUZU No. 892 (1996) 216, 221 (finding no facts to support a conclusion there was an inappropriate solicitation, a violation of the duty to explain, or a violation of the duty to advise).

297. Hiroshima App. Ct., Okayama Branch Decision, May 31, 1996, HANREI JIHO No. 1594 (1997) 90.

298. *Id.* at 95.

299. *Id.* at 96 (finding the plaintiff had a duty to attempt to understand the transaction and setting off 30% of the damages).

300. Osaka Dist. Ct., Sakai Branch, Decision, May 14, 1997, KINYU SHOUJI HANREI No. 1026 (1997) 36.

301. *Id.* at 39, 41-2 (Stating in general terms: "There is a good faith duty of care to, having determined the solicitation of a transaction is not unsuitable in light of the investor's occupation, age, knowledge of securities transactions, experience, and financial means (the suitability principle), provide an explanation and appropriate in-

time the plaintiff purchased the warrants, there was no market in them and a high probability they would expire worthless.<sup>302</sup> In first soliciting the transaction, the broker spent “a mere twenty to thirty minutes” providing a summary explanation, and violated his duty to explain by “not making understood the nature of the transaction.”<sup>303</sup> Moreover, the broker had guided each sale and was aware that the plaintiff was unable to independently make appropriate investment decisions. After selling the warrant, the broker “should have easily foreseen there was little possibility of an upswing in its price and, thus, had a duty to advise the plaintiff on an appropriate time to sell.”<sup>304</sup> The court found that the broker violated a duty to explain and a post-sale duty to advise on when to sell and how to minimize the losses.<sup>305</sup>

The Hiroshima Appellate Court premised liability both on a failure to explain the transaction when it was recommended and a failure to provide “appropriate advice” after the sale and its subsequent decline in value. The “loss of the opportunity” to sell the warrant was an explicit basis for imposing liability. The Osaka District Court likewise explicitly premised the defendant’s liability on both the broker’s breach of the duty to explain and the duty to advise, a duty to “provide advice such as encouraging the sale of the security at an appropriate time.” Both courts could have found for the plaintiff based solely on a breach of the

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formation about the transaction’s structure, substance, profit, and risk so that the investor can based on a correct awareness and understanding determine independently whether or not to undertake the transaction (the duty to explain). In addition, after the transaction, there is a duty to provide information and appropriate advice so that the investor does not unduly suffer losses or prejudice his interests based on mistaken information or understanding (the duty to advise).”).

302. *Id.* at 42.

303. *Id.* at 42-3.

304. *Id.* at 43.

305. *Id.* at 43 (finding defendant liable for the plaintiff’s losses with a 30% set-off for contributory negligence). Cases have also addressed a broker’s ongoing duty to advise in conjunction with the duty to explain, and found the transactions and subsequent events *in toto* showed a breach of the broker’s duty of care. See Osaka Dist. Ct., Dec. 20, 1994, HANREI JIHŌ No. 1548 (1996) 108, 114 (Holding “after the plaintiff purchased the present warrant, the defendant Ōkita’s provision of information to the plaintiff about the price of the warrant was insufficient and thus violated his commitment at the time of the solicitation to provide information about the price of the warrant.” This in conjunction with conclusive evaluations, suitability, and duty to explain issues led the court to conclude there was “strong overall illegality which equate to a tortious act under Civil Code Section 709.”); See also Osaka Dist. Ct. decision, Feb. 23, 1995, HANREI JIHŌ No. 1548 (1996) 114, 120 (After the purchase of the warrant, the broker “did not provide accurate information about the present warrant and it can be said as a result the plaintiff lost the opportunity to sell this warrant and sustained losses.” In conjunction with conclusive evaluations, and duty to explain issues, the court found “strong overall illegality which equate to a tortious act under Civil Code Section 709.”).

duty to explain, but go beyond this and impose an ongoing duty to advise.<sup>306</sup>

Yet other opinions have found a violation of the duty to explain where the broker has not attempted to actively dissuade the investor from undertaking risky or irrational investments.

A broker recommended a warrant transaction to a sophisticated investor, provided the necessary disclosure documents, and explained some aspects of the transaction.<sup>307</sup> After the plaintiff purchased the warrant, it increased in price and the broker recommended selling, but the plaintiff declined. The price subsequently declined, and the *plaintiff* proposed to a second broker a second purchase, in order to decrease his average cost per share.<sup>308</sup> This second broker confirmed the price and sold the warrants "without any special explanation of the risks involved in purchasing additional warrants."<sup>309</sup> The court found there was some question as to the sufficiency of the first broker's explanation, but the plaintiff was an experienced investor and "should have sufficiently understood" the transaction.<sup>310</sup> With regard to the later transaction, however, the court found that "as the defendant's warrant section had voiced concerns to Takahashi [the second broker], as a securities company broker he had a good faith duty to the plaintiff to adequately explain the risks of the additional purchase and to dissuade the plaintiff, to use care to avoid needlessly inflicting losses on the customer."<sup>311</sup>

A later decision involved a couple investing for their retirement. They communicated their wish to invest conservatively, but lacking experience, relied on the broker's recommendations.<sup>312</sup> The trial court found they had bought and sold for a profit a variety of investments including warrants, and had been provided with written disclosure materials but did not read them.<sup>313</sup> The appellate court held the defendant broker had a duty to "explain the basic structure of warrants, as well as ascer-

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306. Some scholars have argued that this duty should be limited to instances where the investor is inexperienced. See Morita Akira, *Shōken Kaisha to Kōkyaku to no Kankei*, MINSHŌ HŌ ZASSHI Vol. 113 No. 415 (1996) 222; Watanabe Masanori, *Waranto Torihiki ni Okeru Tōshi Kanyū to Tōshisha Hogo*, HANREI TAIMUZU No. 870 (1995) 12, 19, 22.

307. Tokyo Dist. Ct. Decision, June 19, 1995, HANREI TAIMUZU No. 890 (1995) 166.

308. *Id.* at 171.

309. *Id.*

310. *Id.* at 172.

311. *Id.* (finding the second broker negligent and the securities company liable for 50% of the losses resulting from the second transaction).

312. Hiroshima App. Ct. Decision, June 12, 1997, HANREI TAIMUZU No. 971 (1998) 170.

313. Yamaguchi Dist. Ct. Decision, Mar. 26, 1996, HANREI TAIMUZU No. 971 (1998) 174, 178.

tain the customer's degree of understanding of the risks involved in the transaction and if necessary meet with the customer, and provide the appropriate information."<sup>314</sup> Given that the price of the stock had dropped below the warrant exercise price, the product's value was its premium value only. The broker "should have explained things to a degree that the plaintiff or his wife Kazuko could understand, and if it is not possible to obtain their understanding, there is a duty to advise them not to undertake warrant transactions."<sup>315</sup> The court found the defendant violated this duty and was liable.<sup>316</sup>

As with the earlier cases finding breach of an ongoing duty to advise, the courts could have premised liability on a simple breach of the duty to explain. In the Tokyo opinion, the court could have found a breach of the duty to explain the mechanics and risks of further purchases. In the Hiroshima decision, the court could have found liability for simply failing to adequately explain the risks. In each case however, one with a sophisticated, independent investor and one with an unsophisticated investor relying on the broker, the courts go a step further and premise liability on the broker's failure to dissuade. The duty goes beyond requiring a securities company to abstain from soliciting unsuitable transactions, and requires the broker to actively dissuade a customer from an unsuitable transaction. This duty of care is extended to create a duty to prevent "needless losses."

In the majority of decisions that require brokers to obtain the subjective understanding of the investor, confirm their understanding, advise them on an ongoing basis, or dissuade them from trading, there are extenuating circumstances. There is clear reliance on the part of the investor, a lack of suitability, or a questionable basis for recommending the transaction. The courts address all of these issues by creating a duty to explain and then interpreting it expansively.<sup>317</sup>

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314. Hiroshima App. Ct. Decision, June 12, 1997, HANREI TAIMUZU No. 971 (1998) 173.

315. *Id.*

316. *Id.* at 174 (setting off plaintiff's damages by 30% for contributory negligence).

317. These additional duties—to confirm the investor's understanding, to advise after the transaction, and in some cases dissuade investors from transactions—are in many ways analogous to duties imposed on fiduciaries in the U.S. See *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal.Rptr. 222, 242 (Cal. Ct. App. 1968) (where investor invariably followed and relied on a broker's recommendations, there is "an obligation to determine the customer's actual financial situation and needs. . . . If, as appears from the evidence and as found by the court, it was improper for her to carry out the speculative objectives which defendants attribute to her . . . there was a further obligation to make this known to her, and refrain from acting except upon her express orders."); *Duffy v. Cavalier*, 264 Cal.Rptr. 740, 750 (Cal. Ct. App. 1989) (There is "a *fiduciary duty* (1) to ascertain that the investor

While courts acknowledge the existence of three distinct duties under the Civil Law—a duty not to provide conclusive evaluations or misleading conclusions about an investment, a duty not to recommend unsuitable investments, and a duty to explain—it is clearly the duty to explain, a duty without basis in the SEL and regulations that has come to dominate.

### III. RECENT LEGISLATION AND NEW PRIVATE RIGHTS OF ACTION

The judicial creation of the duty to explain shaped the debate surrounding the proposed Financial Services Law and the enacted Financial Products Sales Act. The Financial Products Sales Act fills a gap in the SEL by codifying a duty to explain, but what it gives with one hand, it takes away with the other.

#### A. THE FINANCIAL PRODUCTS SALES ACT

As part of the Big Bang reforms, a Finance Advisory Committee (*kinyū shingikai*) was established in 1998 to study implementation of a financial services law, patterned on the English

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understands the investment risks in light of his or her actual financial situations; (2) to inform the customer that no speculative investments are suitable if the customer persists in wanting to engage in such speculative transactions without the stock broker being persuaded that the customer is able to bear the risks involved; and (3) to refrain completely from *soliciting* the customer's purchase of any speculative securities which the stock broker considers to be beyond the customer's risk threshold. As long as these duties are met, if the customer nonetheless insists on purchasing speculative securities, the stock broker is not barred from *advising* the customer about various speculative securities and purchasing for the customer those securities which the *customer* selects."); *Lieb v. Merrill Lynch, Pierce, Fenner & Smith*, 461 F.Supp. 951, 953 (E. D. Mich. 1978) (apart from general duties owed to the customer, including the duty to inform the customer of the risk involved in the particular transaction, the broker in handling a discretionary account becomes a fiduciary in the broad sense and "must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization paper or as apparent from the customer's investment and trading history; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsibly; (3) keep his customer informed as to each completed transaction; and (4) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged." [internal citations omitted]).

Japanese courts have not specifically required that the broker act as a fiduciary in order to impose these duties. The holdings have simply been predicated on a finding of trust and reliance by the investor in their broker. In this sense, the Japanese decisions discussed above follow standards similar to the more liberal U.S. courts that have held confidential and fiduciary relations to exist "whenever trust and confidence is reposed by one person in the integrity and fidelity of another." *Twomey*, 69 Cal.Rptr. at 235. Japanese courts take the opposite tact from those U.S. courts that hold absent a special agreement, a broker owes only a duty to exercise care in executing the principle's orders. *See, e.g., Lefkowitz v. Smith Barney, Harris, Upham & Co.*, 804 F.2d 154, 155 (1st Cir. 1986); *Rude v. Larson*, 296 Minn. 518, 519 (Minn. 1973).

model, which would regulate financial services across the board, including those provided by the insurance, banking, and securities industries.<sup>318</sup> The Financial Services Law was to integrate the disparate provisions found in the Civil Code, the Commercial Code, and industry specific laws, and unify the administrative supervision and inspection of the various providers of financial services.<sup>319</sup>

According to the mid-term report of the Finance Advisory Committee, the markets were to be generally classified into the "wholesale/pro sector," "general retail sector," and "specially designated retail sector."<sup>320</sup> Regulatory efforts were to be divided into an equal number of areas with transaction rules designed to cover the rights and duties of individual parties, market rules to regulate the functioning of the markets, and industry rules to regulate the providers of financial services.<sup>321</sup>

The committee, however, was unable to reach a consensus on the details, and the Financial Services Law foundered.<sup>322</sup> In its stead, an agreement was reached to continue discussions on deregulation and unification of the various industry laws and in the interim draft and submit a more limited bill, which would separately address the solicitation and sale of financial products in the general retail sector.<sup>323</sup> The committee chose to focus on the area in which the judiciary had created an extensive set of legal norms.

The Wholesale/Retail Working Group within the Finance Advisory Committee proposed making explicit the duty to ex-

318. Ōkurashō no Kinyū Shōhin Hanbai•Kanyū Hōan Saiteigen no Shōhisha Hogosaku, ASAHI SHIMBUN CHŌKAN, Dec. 4, 1999, at 11; Morita Muneo, *Kinyū Shingikai Dai I Bu Chūkan Seiri (Dai I Ji) no Gaiyō*, KINYŪ HŌMU JIJŌ No. 1554 (1999) 6, 8 (The Finance Advisory Committee Group was formed by combining the Securities Transaction Advisory Committee, the Financial Systems Investigative Committee, and the Insurance Advisory Committee.). The use of *shingikai*, advisory committees or councils, in the Japanese legislative process is described in HIDEO TANAKA, *THE JAPANESE LEGAL SYSTEM* 55-6 (1976).

319. *Id.* at 8; *Kinyū Shōhin Shinhō, Kanyū Kisei ni Kadai Gyōseibatsu nado ha Mōkezu*, ASAHI SHINBUN CHŌKAN, Dec. 22, 1999, at 12.

320. Morita, *supra* note 318 at 8; Zadankai, *Kinyū Sa-bisu Hō he no Tenbō to Kadai*, KINYŪ HŌMU JIJŌ No. 1535 (1999) 31, 32-3.

321. *Id.*

322. '*Hanbai•Kanyū*' de *Shinhō Kinyū Sa-bisu Hō, Seitei Jiki Shimesezu*, ASAHI SHIMBUN CHŌKAN, Dec. 8, 1999, at 11.

323. *Id.* (According to the Ministry of Finance, the scope of the Financial Services Law, all financial products, was so broad that additional time was necessary to study the issues and reach a consensus on appropriate rules. At the suggestion of Kiichi Miyazawa, then Minister of Finance, it was decided to press forward with an independent bill addressing the sale of financial products.); Ōkurashō no Kinyū Shōhin Hanbai•Kanyū Hōan Saiteigen no Shōhisha Hogosaku, *supra* note 318.

plain and liability for damages resulting from its breach.<sup>324</sup> With regard to the duty to explain, the working group confronted the split in the courts over whether to employ an objective standard or a subjective standard and opted for the former. The duty to explain was framed in terms of a duty which “does not go to the extent of covering correct understanding” for each investor, but to the extent of “providing the necessary information for an understanding” by a reasonable investor.<sup>325</sup> The appropriateness of a subjective standard, as employed by many of the courts, was to remain a subject for further consideration.<sup>326</sup>

In addition, the Wholesale/Retail Working Group sought to clarify suitability related duties. They defined the suitability principle both narrowly and broadly.<sup>327</sup> Narrowly defined, the suitability principle did not permit the solicitation or sale of certain products to certain individuals, but the working group concluded that to establish such transaction rules would be very difficult. It was thought more “appropriate to require the maintenance of systems, such as the maintenance of compliance systems, which include internal rules regarding risk management and legal compliance.”<sup>328</sup> More broadly defined, the group found that suitability issues were an extension of the duty to explain, requiring that solicitation be suitable to the characteristics of the customer, and thus the industry “was expected to self-regulate in the form of conducting explanations fitting to the user (the broad definition of the suitability principle).”<sup>329</sup>

The Law Concerning the Sale of Financial Products (hereinafter Financial Products Sales Act) was enacted on May 23, 2000, largely along these two lines.<sup>330</sup> Its objective is:

[T]o further customer protection and contribute to the development of a sound national economy through the establishment of factors to be explained to a customer in the course of the sale of a financial product by a financial service provider; their liability when the customer sustains losses as the result of the financial service provider not explaining the relevant factors to the customer; and the enactment of measures necessary

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324. Matsuno Tomoyuki, *Kinyū Shingikai Dai I Bukai 'Ho-ruse-ru/Ri-teiru ni Kan Suru Wa-kinguguru-pu' Repo-tono Gaiyō*, KINYŪ HOMU JIJŌ No. 1554 (1999) 11, 16-8.

325. *Id.* at 16.

326. *Id.*

327. *Id.* at 15.

328. *Id.* at 18.

329. *Id.* at 18.

330. The law came into effect April 1, 2001. See *Kinyū Shōhin Hanbai Hō ga Seiritsu, Ginkō Nado Risuku Setsumei Gimu*, Nihon Keizai Shinbun Yōkan, May 23, 2000, available at <http://www2.osk.3web.ne.jp/~syouden/kinyuu/nikkei000523.html> (last visited Jan. 12, 2001).

to secure appropriate solicitation by financial service providers of the sale of financial products.<sup>331</sup>

The law goes on to delineate the financial service providers and the products covered. The latter are specifically enumerated and include: deposits and savings, trusts, insurance products and securities, as well as other products designated by cabinet order.<sup>332</sup> The financial service providers themselves are defined as those engaged in the business of selling financial products, whether acting in the capacity of a principle, agent, or intermediary.<sup>333</sup>

Section 3 is the heart of the statute and sets out the financial service provider's duty to explain. Financial service providers:

must explain the following items (hereinafter material facts) prior to the sale of the relevant financial product:

- 1) If, in relation to the sale of the relevant financial product, as a direct result of fluctuations in interest rates, currency values, market prices in the securities markets and other indices there is a risk of loss of principal, that fact and the relevant indices.
- 2) If, in relation to the sale of the relevant financial product, as a direct result of changes in the financial condition of the party conducting the sale of the relevant financial product or business of another party, there is a direct risk of loss of principal, that fact and the relevant party.
- 3) Apart from factors listed in the previous two subsections, in relation to the sale of the relevant financial product, if as a direct result of other factors stipulated by cabinet order as material facts which influence the decision of the customer, there is a direct risk of loss of principal, that fact and the relevant factors.
- 4) If there are restrictions on the period of time during which a right which accompanies the sale of the relevant financial product can be exercised, or there are restrictions on the period of time during which a contract relating to the sale of the relevant financial product can be rescinded, that fact.<sup>334</sup>

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331. Kinyū Shōhin no Hanbai Nado ni Kan Suru Hōritsu [Law Concerning the Sale of Financial Products] § 1, Law No. 101 of 2000. A slightly different, "unofficial and provisional" translation is available from the Financial Services Agency. Law on Sales of Financial Products, available at <http://www.fsa.go.jp/law/law.html> (last visited Jan. 29, 2001).

332. *Id.* § 2. The act interestingly enough does not cover commodities futures, postal savings accounts, or postal insurance policies. See *Kinyū Shōhin Hanbai Hō ga Seiritsu, Ginkō Nado Risuku Setsumei Gimū*, *supra* note 330; *Kinyū Shōhin Hanbai Hō Saibangai Shori no Seibi wo Isoge*, MAINICHI SHINBUN, June 19, 2000, available at <http://www.13.mainichi.co.jp/eye/shasetsu/200006/19-2.htm> (last visited Jan. 12, 2001).

333. Law Concerning the Sale of Financial Products, § 2 (2) (3).

334. *Id.* § 3 (1)(1-4). When two or more financial service providers are engaged in the sale of a financial product, and there are material facts which must be explained, if such explanation is provided by one of the financial service providers the other need not unless required otherwise by cabinet order. Likewise, where the cus-

Section 4 provides that the financial service provider is liable for compensation of the losses resulting from a failure to explain material facts where such explanation was required,<sup>335</sup> and damages are presumed to be the loss to principal.<sup>336</sup>

In contrast to the specifics of the duty to explain, the suitability principle is treated in more general terms. "Financial service providers, when soliciting as part of its business of selling financial products, must endeavor to insure its appropriateness."<sup>337</sup> The financial service providers must establish, in advance, solicitation policies.<sup>338</sup>

In the solicitation policies, the following factors must be prescribed:

- 1) Factors to be considered in light of the knowledge, experience and financial condition of the party to be solicited.
- 2) Factors to be considered regarding the method and period of time for the solicitation of the party.
- 3) Apart from those factors listed in the previous two subsections, factors ensuring the appropriateness of the solicitation.<sup>339</sup>

The financial service provider is further required to "promptly publish" these policies and their amendments, according to methods established by cabinet order.<sup>340</sup> No private right of action for violation of the suitability principle is established.<sup>341</sup> Financial service providers violating this provision by not establishing a solicitation policy or failing to publicize it are subject to a fine of up to 500,000 yen.<sup>342</sup>

What is absent from the law is as interesting as what has been codified. With regard to the suitability principle, the advisory group displayed the court's hesitance to impose a substantive suitability rule that would provide recourse against financial service providers for the recommendation of an unsuitable transaction.<sup>343</sup> Regardless of Section 43 of the SEL and in spite of

tomor is designated by cabinet order as one who possesses special knowledge and experience regarding the sale of financial products (specified customers), or where the customer has indicated there is no need to explain the material facts, there is no duty to explain. *Id.* § 3(3) and 3(4).

335. *Id.* § 4.

336. *Id.* § 5.

337. *Id.* § 7.

338. *Id.* § 8 (National or local public entities, other parties designated by cabinet order as not presenting a risk of inappropriate solicitation, or those servicing only "specified customers" are excluded from this requirement.).

339. *Id.* § 8 (2).

340. *Id.* § 8 (3).

341. *Kinyū Shōhin Shinhō, Kanyū Kisei ni Kadai Gyōseibatsu nado ha Mōkezu*, *supra* note 319, at 12 (questioning the effectiveness of these provisions).

342. *Id.* § 9.

343. *See supra* Part II.C.

scholarship that argues its independence,<sup>344</sup> suitability issues are interwoven with the duty to explain. As with the regulatory agencies and the self-regulatory organizations, suitability, when treated independently, is addressed exclusively in terms of the development of internal standards and solicitation policies, primarily through minimum standards and customer records requirements.

The duty to explain is codified in the Financial Products Sales Act and fills a gap in the SEL. More important and unusual is that a private right of action is explicitly recognized.<sup>345</sup> The duty is, however, cast in narrow terms that extend no further than the responsibility to explain if there is a risk to the principal of the investment and the risk factors, as well as any time limitations on exercising rights acquired in the transaction.<sup>346</sup> These factors stem directly from problems associated with the sale of warrants and variable life insurance, but fall far short of the breadth required by the courts.<sup>347</sup>

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344. See *supra* Part I.A and Part II.C.

345. See *infra* Part IV.A.

346. Law Concerning the Sale of Financial Products, § 3.

347. The courts have not simply defined risk as loss of principal. In the context of warrants, most courts have outlined a series of either 2 or 4 points "indispensable in an explanation." See Shimizu Toshihiko, *Tōshi Kanyū to Fuhōkōi (4)—Waranto Tōshi Kanyū to Setsumei Gimū*, *supra* note 182, at 82, 88; Kogayu Tarō, *Setsumei Gimū Ihan ni Yoru Fuhōkōi to Minpō Riron (Jō)—Waranto Tōshi no Kanyū o Sozai Toshite*, JURISUTO No. 1087 (1996) 118, 119. See also Osaka Dist. Ct. Decision, Sept. 14, 1994, HANREI TAIMUZU No. 875 (1995) 171, 184 (providing an example of the former, finding that, "1. the price of a warrant and the price of the stock move in same direction with several times the volatility, and 2. once the exercise period passes, the right is extinguished and becomes worthless. . . should be explained to a degree these points can be concretely understood."). See also Osaka Dist. Ct. Decision, Jan. 31, 1996, HANREI TAIMUZU No. 916 (1996) 173. Other courts have required more. See Osaka App. Ct. Decision, Apr. 20, 1995, HANREI TAIMUZU No. 885 (1995) 207, 215 (holding that the broker had a duty to "in light of [the investor's] occupation, investment experience, investment objectives and the like, to sufficiently explain. . . 1. the import of warrants, 2. the meaning of the exercise price, exercise period (and the amount of stock acquired by exercising the right), 3. the mechanism for formation of the price of a foreign currency warrant and the fact that it is a high risk product which can become worthless, and 4. foreign currency denominated warrants in contrast to stocks listed on an exchange are traded with the securities company"); See also Tokyo App. Ct. Decision, Dec. 20, 1995, HANREI TAIMUZU No. 924 (1997) 231. Other courts have found explaining the basic structure of the warrant to be insufficient and required an explanation of the risks which exist even prior to the warrant's expiration, or specific mention if the stock price is below the exercise price at the time of the sale, or of the risks associated with currency fluctuations. See, e.g., Osaka Dist. Ct. Decision, Dec. 16, 1994, HANREI JIHO No. 1564 (1996) 45; Sendai App. Ct. Decision, Oct. 14, 1996, KINYŪ SHŌJI HANREI No. 1009 (1997) 18; Niigata Dist. Ct. Decision, Apr. 13, 1995, HANREI TAIMUZU No. 876 (1995) 209; Hiroshima App. Ct. Decision, June 12, 1997, HANREI TAIMUZU No. 971 (1998) 170. The courts have varied but in some form gone beyond the possibility of loss of principal as the defining measure of risk.

Equally important, the duty to explain in the act stops at the provision of information. The advisory committee and legislature adopted the position of the more conservative courts, and made no allowances for additional duties imposed by some courts where there is reliance by the investor, suitability issues, or questions about the reasonableness of the transactions. Apart from the creation of a category of “specified customers” designated by cabinet order as requiring no explanation, there is no distinction among customers or provision for tailoring the required explanation accordingly. In addition, the duty to explain under the Financial Products Sales Act is envisioned as an objective standard, in contrast to the opinions discussed earlier which “presumed” a breach of the securities companies’ duty to explain based on a lack of understanding by the plaintiff. As a result, this new law is and has been criticized as a step back from the norms established by the judiciary.<sup>348</sup>

The law does not, however, abrogate any provisions of the Civil Code.<sup>349</sup> Duties imposed under the Civil Code remain the same and recourse will continue to be available under the general tort section, Section 709.<sup>350</sup> The Financial Products Sales Act is touted as reducing the plaintiff’s burden of proof by making explicit the financial service providers’ duty to explain, establishing causation between the failure to explain and the investor’s damages, and establishing the amount of damages.<sup>351</sup> This, in turn, is supposed to speed the resolution of disputes handled by the courts,<sup>352</sup> or according to some, make filing lawsuits easier.<sup>353</sup>

The existence of a duty to explain was already firmly established by the courts, as was causation between its breach and the

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348. The Democratic Party and the Japanese Communist Party opposed the enactment of the Financial Products Sales Act on the grounds that the act threatened to lower the duty of care established by judicial precedent. See *Kinyū Shōhin Hanbai Hō Nado Seiritsu: Nihon Kyōsantō ha Hantai*, SHINBUN AKAHATA, May 24, 2000, available at [http://www.jcp.or.jp/akahata/20005/2000524\\_147\\_kinyuu.html](http://www.jcp.or.jp/akahata/20005/2000524_147_kinyuu.html) (last visited Jan. 12, 2001).

349. Law Concerning the Sale of Financial Products, § 6.

350. *Id.*

351. Kinyūchō, Kinyū Shōhin no Hanbai nado ni Kansuru Hōritsu no Gaiyō, available at [http://www.fsa.go.jp/p\\_mof/houan/hou11a.htm](http://www.fsa.go.jp/p_mof/houan/hou11a.htm) (last visited Dec. 5, 2000). See also Financial Services Agency, Outline of the Bill on Sales of Financial Products, available at [http://www.fsa.go.jp/p\\_mof/english/system/fs.003.htm](http://www.fsa.go.jp/p_mof/english/system/fs.003.htm) (last visited Dec. 5, 2000).

352. Kinyū Shōhin no Hanbai nado ni Kansuru Hōritsu no Gaiyō, *supra* note 351; Kinyūchō, Kinyū Shōhin no Hanbai Nado ni Kan suru Hōritsu ni tsuite, available at <http://www.fsa.go.jp/notice/noticej/kinyuusyouhin.html> (last visited Jan. 12, 2001).

353. *Kinyū Shōhin Hanbai Hō ga Seiritsu, Ginkō Nado Risuku Setsumei Gimu*, *supra* note 330; *Kinyū Shōhin Hanbai Hō Saibangai Shori no Seibi wo Isoge*, *supra* note 332.

investor's damages, and the amount of damages awarded.<sup>354</sup> Thus, it remains to be seen how the courts will apply the new law, whether it will reduce the plaintiff's burden of proof and offer a streamlined alternative to Civil Code Section 709 actions as suggested, or be applied as a brake on the more expansive interpretations of the duty to explain imposed by the courts via Section 709. More immediate and clear is the response of the financial service providers. They are preparing for more lawsuits, adopting new guidelines, and revising sales practices with new rules requiring written confirmation of understanding from customers.<sup>355</sup>

## B. THE CONSUMER CONTRACT ACT

The Consumer Contract Act was promulgated May 12, 2000.<sup>356</sup> It applies to all consumer transactions, including those in financial products, and will operate in tandem with the Financial Products Sales Act.<sup>357</sup>

Its origins are in the Consumer Policy Subcommittee of the National Life Advisory Committee (*Kokumin Seikatsu Shingikai*), which began studying consumer transaction issues after the passage of the Products Liability Law in 1994.<sup>358</sup> Over the next five years, the subcommittee held hearings, solicited comments, and issued a series of reports culminating in a January 1999 report. This report concluded that "[a] consumer contract law that concretely establishes civil [law] rules should be enacted as quickly as possible," but noted the need for further study of the details of such an act and for developing a consensus among the affected parties.<sup>359</sup> Without dwelling on the urgency of the message and the five years it took for the advisory committee to send it, the following year brought endorsement of the legislative process as well as position papers by the Ministry of International Trade and Industry's (MITI's) Consumer Economic Subcommittee of the Industry Structure Advisory Group, the Civil Section of the Ministry of Justice, and further word by the Consumer Policy Subcommittee on the specifics of the bill.<sup>360</sup>

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354. See *supra* Part II.

355. Reiko Mase, *Consumer-Protection Laws Put Financial Sector on Edge*, THE NIKKEI WEEKLY, Nov. 6, 2000, at 13.

356. Shōhisha Keiyaku Hō [Consumer Contract Act] Law No. 61 of 2000.

357. Keizei Kikakuchō, Shōhishakeiyakuhō No Pointo, available at <http://www.epa.go.jp/99/c/shouhi/gaiyou/pointo.html> (last visited Dec. 5, 2000).

358. Keizei Kikakuchō, Shōhisha Keiyaku Hō No Kentō Keii, available at <http://www.epa.go.jp/99/c/shouhi/keiyaku.html> (last visited Dec. 5, 2000). The Products Liability Law was passed July 1, 1994. Seizōbutsu Sekinin Hō [Products Liability Law] No. 85 of 1994.

359. Keizei Kikakuchō, Shōhisha Keiyaku Hō No Kentō Keii, *supra* note 358.

360. *Id.*

The debate over the Consumer Contract Act began well before that of the Financial Product Sales Act, but came to occupy a parallel track.<sup>361</sup> After debate in the Diet in March and April of 2000, the bill was enacted in May 2000 and, along with the Financial Products Sales Act, came into effect April 1, 2001.<sup>362</sup>

It has broad goals: to contribute to the stabilization and improvement of the general welfare of the people and to the sound development of the national economy.<sup>363</sup> This is to be accomplished by:

permitting, in light of the disparity in quality and quantity of information and in the negotiating power between consumers and business, the rescission of declarations of intention to offer or accept contracts made by consumers when they are mistaken or harassed by certain acts of business, and by nullifying, in part or in whole, clauses that exempt business from liability for damages or that otherwise unfairly impair the interest of consumers.<sup>364</sup>

The definitions are broad and few exceptions are made. The Act defines consumers as all individuals apart from those contracting as a business or for the purpose of business; businesses are defined as juristic persons, associations, or individuals contracting for business purposes; and consumer contracts as “contracts concluded between consumers and businesses.”<sup>365</sup> In addition to a distinction in the capacity in which an individual acts, the law is applied to agents of the business and the consumer, but not to third parties who have acted in good faith or labor contracts.<sup>366</sup>

In contrast to the Financial Product Sales Act, there is no duty to explain. Businesses are merely exhorted to “exercise consideration in the drafting of the contract so as to make the consumer’s rights, duties and other parts of the consumer contract clear and plain to the consumer,” and in its solicitation the business “must strive to provide the necessary information about the consumer’s rights, duties, and other provisions of the con-

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361. As with the Financial Products Sales Act, the Consumer Contract Act was influenced by the variable life insurance and warrant cases making their way through the judicial system. See Yamashita Tomonobu *Shōhisha Keiyaku Hō Shō Kitei No Ichizuke*, in *SHOHISHA KEIYAKU HO RIPPŌ HE NO KADAI*, BESSATSU NBL No. 54 (1999) 214, 242.

362. Keizei Kikakuchō, *Shōhisha Keiyaku Hō No Kentō Keii*, *supra* note 358.

363. Consumer Contract Act, § 1. For a slightly different, “provisional” translation provided by the Economic Planning Agency see Economic Planning Agency, Consumer Contract Act, available at <http://www.epa.go.jp/99/c/shouhi/keiyaku.html> (last visited Dec. 5, 2000).

364. Consumer Contract Act, § 1.

365. *Id.* § 2.

366. *Id.* §§ 4(5), 5, and 12.

sumer contract.”<sup>367</sup> The consumer, in turn, is exhorted to use the information provided by the business and “strive to understand the consumer’s rights, duties, and other provisions of the contract.”<sup>368</sup> The language is merely hortatory, with a slight differentiation in the duty to explain between businesses that “must strive” to provide the necessary information (*tsutomenakereba naranai*), and consumers who are “to strive” to understand it (*tsutomeru mono to suru*).<sup>369</sup> Regardless of the semantics, the provisions are without legal effect.<sup>370</sup>

The Consumer Contract Act is not without teeth, teeth that will snag the cloth of many financial transactions. Section 4 provides in part:

Consumers may rescind their declaration of intent to offer or accept a consumer contract if concluded because of any of the following enumerated acts by a business in the solicitation of the conclusion of a consumer contract which results in any of the enumerated mistakes made by the said consumer.

- (1) With regard to material facts, to represent that which differs from the truth. [Resulting in] mistake that the content of the said representation is true.
- (2) To provide conclusive evaluations regarding future prices, future sums of money to be received by the said consumer, or future changes in other uncertain items with respect to goods, rights, services, and other objectives of the consumer contract.<sup>371</sup> [Resulting in] mistake that the contents of the conclusive evaluation provided are certain.<sup>372</sup>
- (3) Consumers may rescind their declaration of intent to offer or accept a consumer contract if said consumer mistakenly believes in the non-existence of facts if a business, in the

367. *Id.* § 3.

368. *Id.* § 3(2).

369. *Id.* § 3.

370. The Economic Planning Agency commentary describes them as hortatory provisions (*doryoku kitei*) and states “no legal affect in private law arises” (*shihō teki kōka ha hassei shinai*). See Keizai Kikaku Chō, Shōhisha Keiyaku Hō no Kaisetsu [Commentary on the Consumer Contract Act] (June 2000) 6, available at <http://www.epa.go.jp/99/c/shouhi/keiyaku.html> (last visited Dec. 5, 2000). Hortatory clauses, however, may influence administrative regulation. See UPHAM, *supra* note 211, at 155-56.

371. Conclusive evaluations are defined as statements that represent as certain something which is not, such as stating with certainty that a transaction will be profitable. Commentators have suggested the use of phrases such as “absolute” or “certain” are not a prerequisite, but at the same time indefinite statements such as “you may profit 1 million yen if you complete this transaction” or personal opinions are not conclusive evaluations. See Commentary on the Consumer Contract Act, *supra* note 370, at 10-11.

372. Insurance, securities, commodities and futures transactions as well as real estate and pyramid schemes are areas where improper solicitation through the use of conclusive evaluations are said to be common. The various indices in securities transactions as well as interest rates and currency values are examples of “future changes in other uncertain items.” *Id.*

course of soliciting the conclusion of a consumer contract, represents to the consumer [that] the contract will be in the consumer's interest as to material facts and items related to said material facts, and intentionally fails to convey with regard to said material facts, facts disadvantageous to the consumer (this is limited to facts a consumer would normally believe non-existent based on the said representation).<sup>373</sup>

The failure to provide negative information requires intent, but the right of rescission arising from the provision of a conclusive evaluation or false representation is more liberally construed. There is no requirement of scienter. Representations may be written or oral<sup>374</sup> and material facts are those, which "ordinarily influence the consumer's decision whether or not to conclude the consumer contract."<sup>375</sup> They are enumerated as follows:

- (1) Quality, use and other aspects of the goods, rights, services and other objectives of the said consumer contract.
- (2) The price and other terms of the transaction for the goods, rights, services and other objectives of the said consumer contract.<sup>376</sup>

In order to ensure finality to the contracts, the statute of limitations and the statute of repose are abbreviated. The right of rescission under Section 4 paragraphs 1 through 3 must be exercised within six months of the time ratification became possible or five years from conclusion of the contract.<sup>377</sup>

The Consumer Contract Law goes on to void clauses in consumer contracts that attempt to exempt a business from all liability or from liability for intentional or gross negligence; clauses that set liquidated damages or default damages over a prescribed level; as well as clauses that are void as a violation of the Civil Code Section 1(2), the good faith provision of the Civil Code.<sup>378</sup>

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373. An exception is provided "when despite the business's attempts to convey to the consumer such facts, the consumer hindered such representation." See Consumer Contract Act, § 4(2). The same section goes on to allow consumers to rescind a consumer contract when subjected to harassment such as a business representative failing to leave after being asked by the consumer, or not freely allowing the consumer to leave a place of solicitation. *Id.*

374. Commentary on the Consumer Contract Act, *supra* note 370, at 10.

375. Consumer Contract Act, § 4(4).

376. *Id.* at § 4 (4)(1-2). Material facts are to be determined in light of "the common sense of society" (*shakai tsunen*), and an objective inquiry into whether the average consumer would be influenced by it. See Commentary on the Consumer Contract Act, *supra* note 370, at 19.

377. Consumer Contract Act, § 7. The Civil Code Section 126 generally provides the right of rescission must be exercised within five years from the time ratification is possible or twenty years from the date of the act. Ratification is deemed the time the fraudulent act is discovered. MINPO [Civil Code], Law No. 89 of 1896, § 126.

378. Consumer Contract Law, §§ 8, 9, and 10. The duty of good faith under the Civil Code is set out as follows: "The exercise of rights and performance of duties

The Civil and Commercial Codes remain generally applicable, and any conflicts between this law and private law provisions of any special laws are to be resolved in favor of the special laws.<sup>379</sup>

The Act is designed to provide a remedy where there is a defect of intent which does not rise to the level of fraud, mistake, or duress under the Civil Code.<sup>380</sup> It does so through the establishment of a “new civil [law] rule”<sup>381</sup> that prohibits false representations and conclusive evaluations, or the failure to convey disadvantageous facts that would cause an ordinary consumer to assume such facts do not exist.<sup>382</sup> Mistake based on any of these provides concrete grounds for rescission.<sup>383</sup> In this way, it complements the Financial Products Sales Act by codifying the first of the three duties enunciated by the courts in the securities cases: the duty not to provide conclusive or misleading evaluations.

While the law has been criticized as inadequate,<sup>384</sup> as with the Financial Product Sales Act, the Consumer Contract Act stands out in that it specifically recognizes new private rights of action. One of the immediate goals is to make remedies more easily obtainable by the consumer.<sup>385</sup> The Act was designed to simplify and clarify the lawsuit and to “function as a judicial

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shall be done in faith and in accordance with the principle of trust.” Civil Code, § 1(2), EHS LAW BULLETIN SERIES Vol. II FA-FAA (1961).

379. *Id.* § 11. Commercial code sections limiting avoidance of contracts for subscription of corporate shares are not abrogated by any section of the Consumer Contract Act. *Id.* § 7(2). Commercial Code Section 191 limits the grounds for rescinding or nullifying subscriptions for shares of stock for a period of time after the corporation’s founding or after a shareholder has exercised their right to vote at the inaugural general meeting. SHŌHŌ [Commercial Code] Law No. 48 of 1899, § 191. The Commercial Code also limits nullification or rescission for a period of one year after the date of a change of registration with the issuance of new stock or after a shareholder exercises their rights accompanying subscription. *Id.* §§ 280-312.

380. Keizai Kikaku Chō, Jūrai no Taiō to Sono Genkai, <http://www.epa.go.jp/99/c/shouhi/gaiyou/juurai.html> (last visited Dec. 5, 2000) (The fraud, mistake, and duress provisions of the Civil Code were thought too strict, the general civil law provisions of good faith and conscionability were thought too vague, and many of the voluntary provisions of the Civil Code were being rendered inapplicable by contracts of adhesion.).

381. Commentary on the Consumer Contract Act, *supra* note 370, at 9.

382. Consumer Contract Act, § 4.

383. Commentary on the Consumer Contract Act, *supra* note 370, at 14.

384. The National Federation of Consumer Groups has suggested the law is a step forward, but criticized it for stopping at a duty to provide information that is merely hortatory, limiting the definitions of mistake and harassment, and implementing a shortened statute of limitations and statute of repose. See Zenkoku Shōhisha Dantai Renrakukai, *Shōhisha Keiyaku Hō no Seiritsu wo Mukaete* (Apr. 28, 2000), available at <http://www.shodanren.gr.jp/database/0.29.htm> (last visited Dec. 5, 2000).

385. The legislation is expected to function in the context of litigation by simplifying the disputed issues and making them clearer, as well as making their resolution “easier, faster and improving legal stability.” In the context of alternative dispute

norm" (*saiban kihan toshite kinōu suru*).<sup>386</sup> There is an attempt to simplify judicial resolution without co-opting the process or making the process informal and subject to alternative dispute resolution by a governmental agency.<sup>387</sup>

#### IV. BROADER IMPLICATIONS

There are broader implications to the Diet codifying new private rights of action and passing laws designed to function as judicial norms. The new laws highlight the importance of the judiciary and the lesser role of the regulatory agencies.

##### A. JUDICIAL ACTIVITY

Much has been made of the reticence of the Japanese judiciary.<sup>388</sup> The bench prioritizes legal certainty and consistency in the application of law and hence is conservative in nature.<sup>389</sup>

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resolution, the bill is likewise expected to improve the fairness and ease of administration. See Commentary on the Consumer Contract Act, *supra* note 370, at 2.

386. *Id.*

387. The April 14, 2000 Supplementary Resolution of the Commerce Committee in the Lower House did emphasize the need to further develop alternative dispute resolution institutions, but went on to note that the court system should be readily available to the consumer as a final resort, and the application of the Consumer Contract Act and the addition of provisions for injunctions and class actions should be studied. The Economics and Industry Committee of the Upper House adopted a similar resolution on April 27, 2000, finding that with the passage of the Consumer Contract Act, the improvement and strengthening of alternative dispute resolution bodies should be pursued and their use actively encouraged. At the same time, the Committee resolved that the court system should be readily available to the consumer, and as part of the judicial reform movement the application of the Consumer Contract Act and the rights of injunction and class actions should be studied. *Id.*

388. The stereotype has been described as follows:

Stereotypes abound concerning Japanese law. One of the most widespread is the view that Japan's judiciary plays an extremely limited role. As the litany runs: Japan's is a civil law system. The judges merely interpret presumably all-inclusive codes; they do not create law through precedent in the manner of common law judges. The court's role is further limited by the vaunted non-litigiousness of the Japanese people. Even when cases reach the courts, the Japanese judiciary is a paragon of judicial restraint. Judges hardly ever question the constitutionality of statutes and are loathe to second-guess bureaucrats or the government. Hence, judicial activism is virtually unknown. Furthermore, to the extent courts do play a role, they are conservative in nature. Given this highly circumscribed role, private parties pay little attention to decisions by the courts. Finally, on those rare occasions when the judiciary steps in, the Diet and the bureaucracy are quick to reestablish their dominance, through new legislation taking matters out of the courts' hands.

Daniel H. Foote, *Judicial Creation of Norms in Japanese Labor Law: Activism in the Service of - Stability?*, 43 UCLA L. REV. 635, 636 (1996).

389. JOHN O. HALEY, *THE SPIRIT OF JAPANESE LAW*, 93 (1998). See also MERYMAN, *supra* note 174, at 48-55 (In the civil law tradition, certainty has "come to be a kind of supreme value, an unquestioned dogma, a fundamental goal.").

There are few Supreme Court decisions which challenge the constitutionality of legislative acts and few administrative suits which challenge the actions of the bureaucracy.<sup>390</sup> Furthermore, those judges who make politically incorrect decisions suffer.<sup>391</sup>

The role of the judiciary in fashioning new legal norms in securities cases, however, suggests the need for caution in blanket generalizations about judicial paralysis. The courts' decisions support an understanding of the Japanese judiciary as proactive, at least in the private law arena.

Judicial activism has been documented across the spectrum of private law. The courts played an instrumental role in the early pollution and employment discrimination cases.<sup>392</sup> In the broader context of labor law, the courts have crafted judicial norms which contravene statutory provisions in what has been called "activism in the service of stability."<sup>393</sup> These developments "reflect one common pattern of judicial lawmaking in Japan: development of doctrines that uphold ongoing relationships, despite statutory and contractual provisions authorizing their termination."<sup>394</sup> The same has been found in family law,<sup>395</sup>

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390. Statutes have been held unconstitutional six times since 1947 and there are said to be from seven hundred to eight hundred times as many administrative lawsuits in Germany as there are in Japan. See Hidenori Tomatsu, *Equal Protection of the Law*, in JAPANESE CONSTITUTIONAL LAW 187, 202 (Percy R. Luney, Jr. & Kazuyuki Takahashi, eds. 1993); WATANABE, ET AL., *TEKISUTO BUKKU GENDAI SHIHO (DAI 3 HAN)* 468 (1999).

391. J. Mark Ramseyer & Eric B. Rasumsen, *Judicial Independence in a Civil Law Regime: The Evidence from Japan*, 13 J. LAW, ECON. & ORG. 259, 283-284 (1997). See also J. Mark Ramseyer & Eric B. Rasumsen, *Skewed Incentives: Paying for Politics as a Japanese Judge*, 83 JUDICATURE 190, 191 (Jan./Feb. 2000); J. Mark Ramseyer & Eric B. Rasmusen, *Why is the Japanese Conviction Rate so High?*, 30 J. LEGAL STUD. 53 (2001).

392. See generally UPHAM, *supra* note 211, at 28-77, 124-65.

393. Foote, *supra* note 388, at 637-38. "The courts were not simply filling gaps in the Civil Code or other statutes in response to a newly-arising issue. Rather, they created a major body of law by interpreting seemingly clear statutory and contractual language through a creative use of the abuse of right and other equitable doctrines." *Id.* at 681. The Supreme Court has recently affirmed its willingness to fashion a private remedy in the labor law arena. In March 2000 it upheld a district court decision finding a company liable for the suicide of an employee due to "overwork" or *karōshi*. The Supreme Court remanded the case to reconsider damages after rejecting an appellate court decision that reduced damages from 120 million to 89 million yen. It agreed with both lower courts that the decedent committed suicide because of depression and exhaustion caused by long work hours. The lower courts had emphasized the hours the employee worked were socially unacceptable, but split over whether damages should be offset due to the decedent's contributory negligence. *Karō Jisatsu Soshō no Hanketsu*, HOKKAIDO SHINBUN, Mar. 25, 2000, at 4.

394. Foote, *supra* note 388, at 638-39.

395. See Taimie L. Bryant, *Marital Dissolution in Japan: Legal Obstacles and Their Impact*, 17 LAW IN JAPAN 73 (1984). The Civil Code authorizes divorce where there is "grave cause that makes continuation of the marriage difficult." Civil Code

and landlord-tenant relations,<sup>396</sup> as well as franchisor-franchisee relations.<sup>397</sup>

This judicial activism is not limited to the preservation of relationships or social structures. The courts, particularly Section 27 of the Tokyo District Court, were instrumental in the 1960s and 1970s in developing judicial norms governing the resolution of disputes involving traffic accidents.<sup>398</sup> In the 1980s, Osaka and Tokyo courts began inching their way towards judicial norms which contravene and ameliorate the restrictive territorial provisions of the Japanese bankruptcy laws.<sup>399</sup> In a traffic accident there is no ongoing relationship; in foreclosure or liquidation the courts no longer attempt to preserve the debtor-creditor relationship. In litigation involving securities transactions, the broker-customer relationship is likewise severed, presumably irreparably, at the time of the conflict. The courts are playing an active role not in maintaining relationships, but in balancing individual rights and duties.

In contrast to the traffic accident or bankruptcy cases, judicial activism in securities cases has not been limited to Tokyo or

§ 770(1). Courts, however, have interpreted this provision so that it is almost impossible to obtain a divorce on this basis unless one's spouse consents. "A key reason given for these interpretations of the divorce provisions is protection of the perceived weaker party, especially when that party is blameless. A central theme, however, is maintaining existing relationships." Foote, *supra* note 388, at 691-92.

396. See John O. Haley, *Japan's New Land and House Lease Law*, in *LAND ISSUES IN JAPAN: A POLICY FAILURE?* 149, 158 (John O. Haley & Kozo Yamamura eds., 1992) Civil Code Section 617 permits termination of a building lease on three months notice. However, even with explicit contractual language to the same effect, courts have refused to allow landlords to terminate leases. In cases prior to 1920, courts dismissed the contractual language as non-binding and overrode the Civil Code provision by finding either a custom or an implied intent not to follow that provision. The judiciary "imposed a legal regime in which neither of the parties' stated intentions in their lease contracts nor the provisions of the Civil Code prevailed." *Id.* at 158. The current Land and House Lease Act Sections 6 and 28 require a justified reason (*seitō no jiyū*) for the landlord's termination of a lease. See Shakuchi Shakuya Hō [Land and House Lease Act] Law No. 90 as amended 1996, §§ 6, 28; see also FOOTE, *supra* note 388, at 691; J. MARK RAMSEYER & MINORU NAKAZATO, *JAPANESE LAW: AN ECONOMIC APPROACH*, 37-42 (1999).

397. See *Kenji Kawagoe, Keizokuteki Keiyaku no Shuryō*, NBL No. 345 (1986) 26. Courts have limited termination rights in franchisor-franchisee relationships rejecting as nonbinding boilerplate contractual provisions permitting at-will termination, and requiring a party to show a "serious reason" supporting the termination. See FOOTE, *supra* note 388 at 692.

398. Daniel H. Foote, *Resolution of Traffic Accident Disputes*, 25 *LAW IN JAPAN* 19, 24, 26 (1995) ("[T]he automobile accident standards serve as a testament to the creativity of Japanese judges – one of the foremost examples of conscious and deliberate judicial activism in Japan." Civil Section 27 of the Tokyo District Court was so influential as to be referred to as "the Supreme Court for traffic accident cases.").

399. Kent Anderson, *The Cross-Border Insolvency Paradigm: A Defense of the Modified Universal Approach Considering the Japanese Experience*, 21 *U. PA. J INT'L ECON. L.* 679, 733, 765-78 (2000).

Osaka. While the Osaka and Tokyo courts have handled the bulk of securities cases, courts from Hiroshima to Sendai have addressed the issue with a wide variety of outcomes, resulting in a gradual development of legal doctrine and clarification of the issues.<sup>400</sup> The Japanese courts, in the context of securities litigation, have proactively moved to fill a perceived void in public law protection and provide remedies based on development of legal doctrine most suited to a determination of the rights and liabilities of private actors.<sup>401</sup>

Assuming for a moment that the judiciary is proactive in intervening to shape the rights and duties of private parties, but remains passive when the government is involved, there remains the question of why there is this public law/private law distinction, why the courts as a whole sit mutely in the face of constitutional or administrative claims but bear considerable force in disputes involving private actions. One important factor is history. The Japanese in the Meiji era (1867-1912) undertook, with the assistance of Boissonade, Techow, Roesler and others, to draft a set of codes based on the French and German legal systems,<sup>402</sup> and in those legal systems, civil law or private law was fundamental—"the heart of the legal system."<sup>403</sup>

The public law was examined with a different set of lenses. Among the 19th century German Pandectists, there was:

a kind of negative implication of this private law ideology that an entirely different attitude was appropriate in public law

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400. See, e.g., Tokyo App. Ct. Decision, Oct. 20, 1988, KINYO SHOJI HANREI No. 813 (1989) 24; Tokyo Dist. Ct. Decision, Sept. 17, 1990, HANREI JIHŌ No. 1387 (1991) 98; Osaka Dist. Ct. Decision, June 22, 1992, HANREI TAIMUZU No. 809 (1993) 165; Nagoya Summary Court Decision, June 30, 1993, KINYO SHOJI HANREI No. 943 (1994) 38; Osaka App. Ct. Decision, Feb. 18, 1994, HANREI JIHŌ No. 1524 (1995) 51; Shizuoka Dist. Ct. Decision, Feb. 2, 1995, HANREI TAIMUZU No. 924 (1997) 236; Niigata Dist. Ct. Decision, Apr. 13, 1995, HANREI TAIMUZU No. 876 (1995) 209; Kyoto Dist. Ct. Decision, May 17, 1995, HANREI JIHŌ No. 1581 (1996) 92; Nara Dist. Ct. Decision, Oct. 5, 1995, HANREI TAIMUZU No. 911 (1996) 155; Fukuoka Dist. Ct. Decision, Oct. 19, 1995, HANREI TAIMUZU No. 902 (1996) 133; Yamaguchi Dist. Ct. Decision, Mar. 26, 1996, HANREI TAIMUZU No. 971 (1998) 174; Yamagata Dist. Ct. Decision, Mar. 28, 1996, KINYO SHOJI HANREI No. 1009 (1997) 22; Hiroshima App. Ct. Decision, Okayama Branch Decision, Mar. 31, 1996, HANREI JIHŌ No. 1594 (1997) 90; Kobe Dist. Ct. Decision, July 18, 1996, HANREI TAIMUZU No. 927 (1997) 176; Nagoya App. Ct. Decision, Oct. 2, 1996, HANREI JIHŌ No. 1594 (1997) 90; Sendai App. Ct. Decision, Oct. 14, 1996, KINYO SHOJI HANREI No. 1009 (1997) 18; Maebashi Dist. Ct. Decision, June 9, 1997, HANREI JIHŌ No. 1645 (1998) 113; Miyazaki Dist. Ct. Miyakanojō Branch, Mar. 25, 1998, KINYO HOMU JIJŌ No. 1516 (1998) 47; Supreme Court Decision, June 25, 1998, KINYO HOMU JIJŌ No. 1522 (1998) 9.

401. See *supra* Parts I, II.

402. JOHN O. HALEY, AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX 70-80 (1991).

403. Merryman, *supra* note 174, at 62, 68. (Even today, "[c]ivil law is fundamental law. It is studied first.")

matters. There the role of the government was not limited to the protection of private rights; on the contrary, the driving consideration was the effectuation of the public interest by state action. . . . In private legal relations the parties were equals and the state the referee. In public legal relations the state was a party, and as representative of the public interest (and successor to the prince) it was a party superior to the private individual. The development of these two quite different ideologies of private law and public law further embedded the distinction in the legal order."<sup>404</sup>

This view of the role of public law fit in neatly with the Japanese view of government, and arguably became imbedded in the judiciary's interpretation of its role in the public law arena.<sup>405</sup> In private law actions, the court is free to operate as a referee and at times act quite aggressively to formulate or reorder the rules governing the parties in order to level the playing field. The same freedom does not exist with public law issues.<sup>406</sup>

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404. *Id.* at 92-3.

405. Pre-Meiji Japanese law with its Chinese origins was fundamentally a public law regime—law was restricted to regulatory statutes and administrative instructions. To that extent it is contrary to the Roman law emphasis on private law. At the same time, however, the early German notion that the state's interests were superior to those of a private actor was in total agreement with the early Chinese and Japanese view of law as an instrument of the state. See HALEY, *supra* note 211, at 19-24.

406. It has been persuasively argued that the Liberal Democratic Party indirectly controls the judiciary. The LDP has for most of the post-war era controlled the cabinet and the prime minister who appoints Supreme Court justices. The Supreme Court justices, one of whom traditionally has experience working in the Secretariat, controls the Secretariat which in turn exercises control over the judicial ranks through an incentive structure of selective promotions and transfers which is systematically biased in favor of the LDP. See J. MARK RAMSEYER & FRANCES M. ROSENBLUTH, *JAPAN'S POLITICAL MARKETPLACE* 178-79 (1993); Ramseyer & Rasmusen, *supra* note 391, at 195.

Given the history of the judiciary, the question is raised whether the restraints are applied not by the LDP, but by an independent Supreme Court and Secretariat, conservative institutions interpreting their judicial mandate conservatively in the public law arena, but less so with private law. There is evidence suggesting that in the private sector the judiciary is perfectly willing to create judicial norms and remedies antithetical to the LDP, big business, and the bureaucracy – the iron triangle. The LDP has never been a friend of labor, yet the dismissal of employees is said to be the most strictly regulated in the world and the courts' stringent requirement crafted in contravention of at-will provisions in the labor laws. See LOUIS D. HAYES, *INTRODUCTION TO JAPANESE POLITICS* 100, 116 (1995); Foote, *supra* note 211, at 636-37. The expansion of the individual investor's rights and remedies raises similar questions. The LDP is not known as an advocate of consumer interests, yet the judiciary has imposed new and significant duties on financial service providers and created a private cause of action where none existed previously. The result has been liability for the industry, costs related to compliance, and restrictions on trade. See *supra* Part II.

While labor law and securities law issues are not as politically charged as the Article 9 cases upholding the constitutionality of Japan's Self-Defense Force or the Election law cases upholding canvassing and voting procedures favorable to the LDP, they are relevant to political interests. At the very least, in a private law deter-

The securities law cases and the resulting Financial Products Sales Act and Consumer Contract Act also suggest that the judiciary has won increasing acceptance from the bureaucracy, the Liberal Democratic Party (LDP), and in turn the Diet for its larger and independent role in the private law arena. In the pollution and employment discrimination cases of the 1960s, 1970s, and 1980s, the central government followed judicial development of new rights and remedies and then reasserted control of the process.<sup>407</sup> "Instead of tolerating the continuation and expansion of the judicial role, the bureaucracy step[ped] in to recapture control of the social agenda."<sup>408</sup> They enacted new laws codifying some of the norms, and stymied further development through the creation of informal governmental and quasi-governmental alternative dispute resolution panels.<sup>409</sup> The creation of private rights of action was specifically avoided.<sup>410</sup> The Financial Products Sales Act and the Consumer Contract Act mark a break with this past. While the government has stepped in, reasserted control over the process, and codified more conservative positions than found in much of the case law, through these two recent bills they have specifically recognized new private rights of action. The bills were enacted with the understanding that more private law suits would follow.<sup>411</sup>

There are incidental and ongoing efforts to revise and invigorate relevant alternative dispute resolution institutions, yet the legislative effort worked to streamline the judicial process by making the rights and duties of the parties explicit rather than removing that process from the courts' purview.

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mination of the respective rights and duties of private parties, the judiciary appears willing to move at cross purposes with common LDP interests.

407. UPHAM, *supra* note 211, at 163, 18-22, 53-163 (There is a "time honored Japanese pattern of dealing with social conflict by simultaneously ameliorating its causes and incorporating the antagonists into government-controlled mediation machinery.").

408. *Id.* at 27.

409. *Id.* This well-worn approach was taken as recently as the mid 1990s when MITI requested that each industry set up a mediation organization to handle disputes in conjunction with passage of the new Products Liability Law. See Andrew M. Pardieck, *Virtuous Ways and Beautiful Customs: The Role of Alternative Dispute Resolution in Japan*, 11 TEMP. INT'L & COMP. L.J. 31, 52 (1997).

410. UPHAM, *supra* note 211, at 27, 219 ("Both the deliberate exclusion of private causes of action for discrimination in the Special Measures Law for Assimilation Projects and the Equal Employment Opportunity Law and the government's reactions to the possibility of increased litigation posed by proposals for a legally binding environmental impact assessment requirement clearly imply a hostility to independent legal action.").

411. See *supra* text accompanying notes 385-87. See also *Kinyū Shōhin Hanbai Hō Saibangai Shori no Seibi wo Isoge*, *supra* note 332 ("It can be assumed that after this new law takes effect, the cases which will be brought before the civil courts will not be few in number. . .").

The Financial Products Sales Act and Consumer Contract Act show an increased willingness on the part of the central government for the judiciary to play an active role and ensure the judiciary will remain influential.

## B. REGULATORY PASSIVITY

Regulatory activity has received as much if not more attention than the role of the courts. On the one hand, there is an early conception of the Japanese bureaucracy as almighty and administrative guidance (*gyōsei shidō*) pervasive.<sup>412</sup> Examples of the heavy hand of the Ministry of Finance and MITI abound.<sup>413</sup> On the other hand, lax regulatory oversight by Japanese ministries and agencies is also well known.<sup>414</sup> The SESC falls neatly into neither category. Since its inception, it has aggressively pursued cases involving illegal loss compensation, market manipulation, and insider trading.<sup>415</sup> It simply has not done the same with fraud in the retail market.<sup>416</sup>

As with judicial activism, there are no clear answers for the selectiveness of the SESC. There are however partial answers. One might point to a regulatory culture that is the antithesis of that of the judiciary. Whereas the judiciary has proven extremely reluctant to interfere in governmental action, there is a similar reluctance on the part of regulatory agencies to interfere or pass judgment on what they consider to be disputes between private parties.<sup>417</sup> Instead, the SESC directs its efforts towards loss compensation, market manipulation, and other issues they perceive

412. Daniel H. Foote, *Resolution of Traffic Accident Disputes and Judicial Activism in Japan*, 25 *LAW IN JAPAN* 19, 24 (1995) (there is a "strong theme in western writing in Japanese law concerning primacy of the administrative realm").

413. See, e.g., UPHAM, *supra* note 211, at 166-204; Mark A. Levin, *Smoke Around the Rising Sun: An American Look at Tobacco Regulation in Japan*, 8 *STAN. L. & POL'Y REV.* 99, 101-05 (1997).

414. See LEVIN, *supra* note 413, at 103-105.

415. See *supra* Part I.A.2.

416. In recent years, the SESC has paid more attention to the retail markets. In the 2000 investigative year, the SESC issued five recommendations for misrepresentations of material fact, as compared to a total of five issued in the previous five years. In contrast to these five recommendations, however, for 2000 alone there were twenty-three loss compensation related recommendations and thirty-six discretionary trading related recommendations. See SESC, 2000 ANNUAL REPORT, app. 2-3(3). In February of 2001, the SESC launched an investigation into the marketing of exchangeable or convertible bonds. However, in addition to concerns about related breaches of the duty to explain, there was an underlying suspicion of market manipulation with securities companies buying linked stocks to bolster prices. See *Agency Investigating Marketing Practices*, THE NIKKEI WEEKLY, Feb. 19, 2001, at 15.

417. See, e.g., Fujita Tokiyasu, *Minji Fukainyū in GYŌSEIHO NO SŌTEN* (SHINHAN) 240 (Narita Seakira ed. 1990) (discussing the basic premise that police intervention is appropriate only when public safety and order are affected); Tamura Masahiro, *Minji Fukainyū no Gensoku ha Naze Ayamari na no ka*, KEISATSU

to threaten the integrity of the markets as a whole. Individual complaints are actively directed to the mediation body administered by the JSDA.<sup>418</sup> The distinction between the public nature of protecting the fairness of the markets and the private nature of protecting the interests of the individual investor, while short-sighted, comports with the public law/private law divide which pervades the judiciary.

The distinction is reinforced by limitations on resources and authority. In understanding the SESC's inaction in policing secondary market transactions involving the general investor, structural issues predominate. There is institutional incapacity similar to that documented in the judiciary and the procuracy, other branches of government charged with applying and upholding the law.<sup>419</sup> In the case of the SESC, this includes insufficient personnel, limited authority, and limited remedies.<sup>420</sup>

The SESC has 112 people on staff.<sup>421</sup> Including those from the Regional Financial Bureaus assisting the SESC in its inspections and investigations, the number increases to 250.<sup>422</sup> In contrast, there are approximately 3,200 at the SEC.<sup>423</sup> A simple numerical comparison is of course unfair. In the United States, the SEC regulates larger markets and more broker-dealers,<sup>424</sup> and in Japan there is a division of labor among the Ministry of Finance, the Financial Services Agency, and the SESC.

However, the limitations extend beyond the numbers to the SESC's authority and its ability to conduct thorough investiga-

KORON Vol. 54 No. 12 (1999) 54 (criticizing as inadequate police response to civil disputes).

418. See *supra* Part I text accompanying note 151.

419. See generally John O. Haley, *The Myth of the Reluctant Litigant*, 4 LAW IN JAPAN 359 (1978); John O. Haley, *Sheathing the Sword of Justice in Japan: An Essay on Law without Sanctions*, 8 J. JAPANESE L. STUD. 265 (1982); J. Mark Ramseyer & Eric B. Rasmusen, *Why is the Japanese Conviction Rate so High?*, J. L. STUD. 53 (2001).

420. See *supra* Part I.A.1; see also *Securities Watchdog Seeks Staff*, THE NIKKEI WEEKLY, August 13, 2001, at 13 (discussing the need to double the number of inspectors and investigators as well as proposals for added authority for the SESC). Structural issues are also important in understanding the JSDA. Unlike the NASDR, the JSDA is not an independent institution established to monitor its member firms, but part of an organization which functions both as an industry association and self-regulatory body. There are a limited number of inspectors devoted to regulatory activities in an organization structured and viewed as an industry association. See *supra* Part I.B.1.

421. See *supra* Part I note 40.

422. *Id.*

423. *Id.*

424. In 1999, there were over 8,000 registered broker-dealers in the U.S compared with 538 members of the Japan Securities Dealers Association. See SEC, 1999 ANNUAL REPORT 27, available at <http://www.sec.gov/about/annrep.shtml> (last modified Sept. 7, 2000); Nihon Shōkengyō Kyōkai, *Gaiyō* (1999), available at <http://www/jstda.or.jp/html/gaiyou/gaiyou.html> (last visited Aug. 12, 1999).

tions. The General Inspection Section has the power to make on-site inspections, review the books, and demand production of documents, but only the Special Investigation Section, which is limited to investigation of criminal wrong-doing, has the power to summon witnesses, obtain warrants, and conduct forced investigations.<sup>425</sup> While the SEC in the United States conducts sweep and cause examinations in addition to regular inspections, the SESC lacks authority to do so in non-criminal investigations.<sup>426</sup> As a result, the kind of disputes and broker misconduct that has occupied the Japanese courts has slipped through a regulatory crack.

When the SESC discovers problematic behavior, it faces similar limitations in the remedies available. There is no power to order disgorgement, civil sanctions, or even levy administrative fines. There are no administrative injunctions or cease and desist orders. There are no negotiated settlements. There are only *kankoku*, *kokuhatsu*, or *kengi*. The SESC can recommend administrative action, send papers to the prosecutors, or suggest the need for adding or revising regulations.<sup>427</sup> In doing so, it is faced with the time-consuming task of processing such recommendations through another bureaucratic agency. In each case it is reinventing the wheel. The easy alternative, given limited resources, is to simply point out the problem and take no action.<sup>428</sup>

Institutional incapacity, for all of the reasons mentioned, results in self-imposed limitations on the SESC's regulatory activities. These limitations manifest in various ways, including in an unwillingness to broadly interpret applicable statutes and regulations, and in an almost uniform emphasis on written proof.

Prior to the enactment of the Financial Product Sales Law, there was no specific provision setting out a "duty to explain," and the general fraud provision had long been abandoned as dead letter.<sup>429</sup> To aggressively pursue activities the courts were sanctioning would have required liberal interpretation of SEL Section 42 and its prohibition on conclusive evaluations, or liberal interpretation of Section 4 of the Order Concerning Regulation of Conduct of the Securities Companies which prohibited the making of false or misleading representations of material facts.<sup>430</sup> With limited resources, the obvious choice was to sanction clear-cut violations, e.g. loss compensation and discretionary

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425. SESC, 1998 ANNUAL REPORT 37.

426. See *supra* Part I.A.1.

427. *Id.*

428. *Id.*

429. See *supra* Part I.A.2.

430. *Id.*

trading which are clearly prohibited, as opposed to violations of the duty to explain which required creative pleading.<sup>431</sup>

SESC and JSDA inspections have also been limited by an emphasis on paper violations. There is a long history of the written word, or character, taking precedence,<sup>432</sup> and both the SESC and the JSDA have followed this tradition and focused almost exclusively on record violations. SESC sanctions for false representations almost always stem from written memoranda, account statements, or other records.<sup>433</sup> Problems in the area of business practices, while including suitability issues and the failure to explain, arise in cases where the inspected securities company has made redemptions during an investment trust's closed period, where there was obvious churning, or in other transactions which leave a paper trail.<sup>434</sup> The immediate impact of the focus on paper is that the scope of regulatory activity is necessarily limited, and the evidentiary burden of the regulators in proving a violation decreases.<sup>435</sup>

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431. The choices faced by the SESC are similar to those faced by the procuracy. When faced with limited resources, attention inevitably will be directed to cases most likely to result in conviction or sanction. See Ramseyer & Rasmusen, *supra* note 391, at 54, 62-4.

432. See HALEY, *supra* note 211 (Even in the early adjudicatory hearings of the Kamakura Bakufu, 1192-1333, "[t]he outcome of the process depended primarily upon the persuasiveness of the parties' documentary evidence, especially the availability of official instruments or records issued by court officials or the bakufu.").

433. See *supra* Part I.A.2.

434. See *supra* Part I.A.3. The JSDA has characterized incomplete recording of customer records as a rule violation "relating to the suitability principle," as are delays in obtaining written confirmations or in provision of account or transaction statements. All are based on the written record, as are the other infractions noted, such as loans to customers, loans of accounts and fictitious names, incomplete recording of insider trading records and the like. See *supra* Part I.B.2.

435. SESC officials have acknowledged informally that given the difficulties of proving fraud or misrepresentation, there may be a tendency to focus on issues easier to prove. Officials in the JSDA also cite difficulties of proving violations of the duty to explain, misrepresentations, or unsuitability. Interview with JSDA official, in Tokyo, Japan (Sept. 3, 1999); Interview with SESC official, in Tokyo, Japan (Sept. 2, 1999). In the case of the JSDA, there are additional factors. The JSDA has come to rely on the SESC and view its own role as distinctly secondary. It operates in a culture where "if the judgment by an equal is scorned, the judgment of the government is permitted." Shōken Torihiki Hō Kenkyūkai, *Heisei 4 Nen Shōken Torihiki Hō no Kaisei ni tsuite (12)—Shōkengyō Kyōkai (1)*, INBESUTOMENTO (Apr., 1994) 76, 92. History provides a partial explanation. The concept of an SRO was imported from the U.S., but the workings of the Japanese industry associations have a long native history. "In the background of the unsatisfactory performance of self-regulatory organizations in Japan was a condition where self-regulation as a system was introduced, but the understanding of the parties involved was grossly insufficient, and regulation of the securities markets had been accomplished by administrative guidance." See RINJI GYŌSEI KAIKAKU SUISHIN SHINGIKAI, SHŌKEN•KINYŪ NO FUKŌISEI TORIHIKI NO KIHONTEKI ZESEISAKU NI KANSURU TŌSHIN (Sept. 13, 1991), in Kawamoto, Ichiro, *Jishu Kisei Kikan—Shōkengyō Kyōkai wo Chūshin ni Shite*, HŌGAKU KYŌSHITSU No. 162 (1994) 60.

Why create a regulatory agency with such limited resources and limited powers? Again, there are a number of possible reasons. In contrast to the SEC, which was created in response to the stock market crash and ensuing Great Depression—a crisis of mammoth proportions, the Japanese SESC was a limited response to what was perceived as a limited problem, primarily the loss compensation scandal.<sup>436</sup> Second, it was created in a climate that continued to prioritize industry growth over investor protection.<sup>437</sup> The Ministry of Finance has been criticized for its protective posture, and while there is no evidence of such an attitude within the current SESC, such an attitude is well entrenched within policy makers.<sup>438</sup> When the SESC was established there were calls for a regulatory agency modeled after the SEC. A predominant rationale for not creating such an institution was that there was no need.<sup>439</sup> It was argued the Japanese licensing system which controlled entry into the industry coupled with regulations controlling the marketing of financial products acted as an effective gate-keeper, allowing the relationship between agency and industry to be based on trust rather than suspicion.<sup>440</sup> Schol-

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436. See *supra* text accompanying note 27.

437. Industry protection remains a mantra for many, with some commentators pointing to Japan's experiment lowering the cost of derivative lawsuits as a poignant example. See Zadankai, *Kinyū Sa-bisu Hō he no Tenbō to Kadai*, KINYŪ HŌMU JIJŌ No. 1535 (1999) 31, 51 ("One absolutely must not forget our experience when the filing of derivative lawsuits was made easier and the initial severity of the lawsuit abuse hardened the economic world's negative thinking about current corporate law.").

438. Comments by the former head of the Financial Reconstruction Commission in February of 2000 are indicative of these attitudes. Ochi Michio resigned after a speech to a group of bankers in which he indicated he would "make allowances" for them in upcoming inspections. Since his time as head of the LDP Financial Problems Investigative Committee, he has long been an outspoken advocate of strong protective measures for the industry. See *Gyōkai Yori Shisei Kawarazu Ochii Michio Kinyū Saisei Iinchō "Tegoro Hatsugen" De Kōtetsu*, ASAHI SHINBUN, Feb. 26, 2000, at 1. More recently, Shinsei Bank Ltd., the first bank bought by foreigners, was forced to establish a more lenient credit policy following criticism by Japanese politicians and a "routine" audit by the Financial Services Agency. See Jason Singer & Phred Dvorak, *Shinsei Bank Pressured To Keep Shaky Loans*, THE WALL STREET JOURNAL, Sept. 26, 2001, at C1.

439. There were those who advocated an institution along the lines of the SEC, and those who argued "an institution with stronger investigatory authority such as the SEC in the U.S. does not fit the Japanese landscape." *Shijō Jōka he 'Dokuritsu' Dō Kakuho*, NIHON KEIZAI SHIMBUN, Aug. 29, 1991, at 3.

440. It was argued that the SEC and the institutions it inspected had the "relationship of a cop and a person suspected of a crime," as compared to the relationship between financial institutions and administrative agencies in Japan which were "based on trust." *Sonshitsu Hoten Mondai kara Nani wo Manabu Ka*, KINYŪ ZAISEI JIJŌ Sept. 26, 1991, at 28. The basis of this trust was preventive maintenance and the ability of the Ministry of Finance to control entry into the market through its licensing system. The former head of the Ministry of Finance Securities Department described the situation as follows:

ars also made self-serving arguments that Japan did not suffer from the same degree of fraud and abuse found in the United States and, thus, there was no need to create a regulatory body with broad ranging investigative powers.<sup>441</sup>

The problems that came to light in the aftermath of the Bubble suggest they were mistaken and the 'gate-keeping' left much to be desired, yet this has not resulted in any increase in authority or resources for the SESC. Likewise, the recent deregulation of the licensing system has not resulted in change. Conflicting priorities and structural problems remain.

It remains to be seen whether the Big Bang reforms and continued governmental restructuring will empower or impede the SESC, and whether the judiciary will continue to lead or fall back to a supporting role in the development of securities law and related norms.

## V. CONCLUSION

There is a Sufi story of the philosopher-fool Mulla Nasrudin. His friends find him one evening looking for his keys under a street lamp. They join in the search, and after some time, one of them finally asks the Mulla where he thought he had dropped the keys. Mulla Nasrudin points to a place some distance away, and the friend asks in exasperation "Why are we searching under the street lamp?" Mulla Nasrudin replied, "The light is better here!"<sup>442</sup>

The Japanese judiciary's proactive role in shaping the rights and remedies of individual investors and the SESC's passive role in regulating a large portion of the retail market have escaped the light of the English language press and academics. An

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America has a registration system, and a variety of people gather in the securities market. . . a police type institution becomes necessary. However in Japan, for close to 30 years there has been a licensing system, and it will not change to a registration system now. . . if an American-style SEC is really created, the licensing system should be dropped, and a registration system must be implemented.

Sakano Tsunekazu, *Shōkengyōkai he no Katafurigyōsei ha Owari ni Subeki Da—Beikokugata SEC yori Okurasho no Kansai Taisei Kyōkade*, EKONOMISUTO, July 30, 1991, at 13, 14. Mr. Sakano's words were prophetic, but only partially accurate. The licensing system has been replaced by a registration system, and the SESC has been given a mandate to police, albeit without sufficient authority to do so.

441. See Kawamoto & Ōtake, *supra* note 212, at 290 (suggesting that in comparison to the U.S., "there are likely not such pernicious securities companies in Japan, and there are not likely to be in the future.").

442. A variation of the tale is found in IDRIES SHAH, *THE EXPLOITS OF THE INCOMPARABLE MULLA NASRUDIN* 26 (1972). Mulla Nasrudin appears in the folklore of Turkey, Greece, and in variant forms throughout Russia and parts of Europe. *Id.* at 11.

awareness of both are central to understanding how the financial markets in Japan are regulated and how the judiciary functions.

Review of the administrative actions of the SESC and JSDA reveal an emphasis on loss compensation, discretionary and insider trading, and other issues considered a threat to the integrity of the markets. Both regulatory bodies recognize the existence of a duty to explain and a duty not to make unsuitable recommendations or provide conclusive evaluations, and they find numerous violations. Yet, they do not sanction. It is the courts that have regulated the rights and duties of the general investor and the securities company. In the process, they have altered the landscape of Japanese securities law. Courts have acknowledged the existence of a duty not to mislead or provide conclusive evaluations and a duty not to provide unsuitable recommendations, both grounded in the public law. However, the focus has been on the duty to explain, a duty with no basis in the public law. The courts have subsumed all other inquiries into this duty to explain, expanding it in some cases to encompass subjective standards requiring the understanding of the investor, and in others to include an ongoing duty to advise or dissuade the investor.

The work of the judiciary in fashioning new duties and new rights has instigated new legislation, the Financial Product Sales Act and the Consumer Contract Act. Both pieces of legislation codify positions taken by more conservative courts. The Financial Product Sales Act codifies an objective duty to explain and the Consumer Contract Act limits the basis for rescission. The new legislation, however, breaks with the past in codifying new private rights of action. The role of the judiciary as a central arbiter of private rights and duties is codified, rather than legislation being enacted to prevent further action by the courts through government sponsored and mandated mediation and conciliation commissions.

The new legislation applies to almost all financial transactions and ensures the courts will continue to play an active role. The changes suggest that judicial resolution of private disputes and development of legal norms will share equal billing with government application of public law and administrative guidance.