JAPAN’S FINANCIAL INSTRUMENTS AND EXCHANGE LAW: HERCULES OR HYDRA?

Clark T. Wisenbaker*

TABLE OF CONTENTS

I. INTRODUCTION ......................................................... 474

II. THE ROOTS OF REFORM .............................................. 478
   A. SOX: Conditions Contributing to the Inevitable Enron Bombshell .............................................. 478
      1. Lack of Auditor Independence ................................. 480
      2. Weak Corporate Governance and Ethics ................. 480
   B. The FIEL: Structural, Cultural, and Political Factors in Japan, and the Inevitable Livedoor Bombshell .......... 482
      1. Structural Factors ........................................ 485
      2. Cultural Factors ......................................... 489
      3. Political Factors ....................................... 490
      4. Livedoor ............................................... 492

III. THE HARMONY AND THE DISSONANCE ......................... 494
   A. Common Ground ............................................. 494
   B. Parting Ways ............................................... 498

IV. THE ROAD AHEAD .................................................... 502
   A. SOX: Criticism and Benefits ................................ 502
   B. The FIEL: Post-Passage Developments as a Window to Its Future .......................................... 504

V. CONCLUSION .......................................................... 508

* J.D., University of Georgia School of Law, 2010; B.A., Mercer University, 2000. The status of the law and any pending reforms discussed in this Note is current as of the time of publication. I thank Robert P. Bartlett III, John O. Haley, Peter B. Rutledge, and Margaret V. Sachs for their invaluable input. This Note also benefited from the guidance and hard work of the members of the Georgia Journal of International and Comparative Law, though I remain responsible for all errors and opinions. I dedicate this Note to Yukie and Yurina, for whose support I am ever thankful.
I. INTRODUCTION

The stability and growth of domestic financial markets rarely escape the attention of a nation’s policy makers. Such has been particularly true in Japan, where economic stimulation has been a top priority since the collapse of its bubble economy in the early 1990s. Over a decade later, “the year 2006 may come to be remembered as a watershed in Japan’s long journey toward modernization of its capital markets and securities regulatory system.”

That “watershed” year saw a sea-change of legislative and economic activity. Most provisions of the comprehensive new Companies Law, passed by the Diet (Japan’s national legislature) the year before, went into effect in May 2006. September 2006 saw reformist Prime Minister Junichiro Koizumi retire after having spearheaded the privatization of Japan’s $3 trillion postal system. Further, on June 14, 2006, the Diet passed the Financial Instruments

---


Two of the major problems which beset the Japanese economy are the banks’ non-performing loans and deflation. The banks had made loans to companies . . . secured on assets, the value of which were greatly inflated during the bubble. As asset prices fell the banks found themselves with increasing bad loans. Since corporate bankruptcy is generally discouraged in Japan, the banks have found themselves carrying approximately ¥150 trillion in bad loans. None of the numerous efforts to clean up the banking sector have so far completely solved the problem. In addition, deflation effectively lowers wages which in turn discourages investment and spending, further contributing to the economic downturn.

Id. at 348 n. 160 (internal citations omitted).


3 Kaisha ho [Companies Law], Law No. 86 of 2005 (Japan).


5 Michael Doyle et al., Asia and Pacific Law, 41 INT’L LAW. 711, 720 (2007). Aside from being a postal system, Japan Post is easily the world’s largest financial institution. It not only operates Japan’s sprawling post offices and mail delivery system, but also runs the world’s largest private savings bank and life insurance company, accounting for 30 percent of Japan’s individual savings, 40 percent of Japan’s life insurance market, and 25 percent of all personal assets in Japan.

Id.
and Exchange Law (FIEL), a sweeping overhaul of the outdated and ineffective Securities and Exchange Law.\(^7\)

The comprehensiveness of the FIEL’s reformulation of Japan’s securities laws cannot be overstated. The thousand-page statute amends some eighty-nine different laws, some of which were abolished entirely to be merged into the FIEL.\(^8\) The FIEL’s revisions begin with broadened definitions of “security” and “derivative transaction,” thereby “greatly expand[ing] the scope of the government’s regulatory power.”\(^9\) Now, if a product has a “security-like feature,”\(^10\) it is subject to the FIEL’s substantive provisions, which impose stringent disclosure rules,\(^11\) internal-control reporting requirements,\(^12\) new rules governing the timing and disclosure of corporate-takeover bids,\(^13\) and increased penalties for securities fraud and insider trading.\(^14\)

Given the FIEL’s sweeping breadth, it is not surprising that its stated purposes are equally bold.\(^15\) Specifically, the law aims to: (1) “compile comprehensive and cross-sectional rules for user protection and to develop an

\(^6\) Kinyu shonin toriniko [Financial Instruments and Exchange Law], Law No. 2 of 1948 (amended 2006) (Japan), translated in 6.1 EHS LAW BULL. SER. No. 6600 (2007) [hereinafter FIEL]. The FIEL was adopted in conjunction with the Coordination Law for Amending the Securities and Exchange Law and Other Financial Laws, Law No. 66 of 2006 [hereinafter all references to the FIEL will refer both to the FIEL and its companion Coordination Law].

\(^7\) Shokentorihiki ho [Securities and Exchange Law], Law No. 25 of 1948 (as amended) (Japan); see Joseph J. Norton & Christopher D. Olive, Globalization of Financial Risks and International Supervision of Banks and Securities Firms: Lessons from the Barings Debacle, 30 INT’L LAW. 301, 303 (1996) (noting “[f]inancial and technological innovations have rendered the segmentations and restrictions on the banking and securities markets, such as those engendered by...the Japanese Securities and Exchange Law, ineffective to prevent instability and contagion”); see also Small, supra note 1, at 320–29 (arguing that Japan’s concept of law and the structure of Japan’s economy and society were not conducive to the Securities and Exchange Law taking root and, further, that the actions of the Japanese government in the years following the promulgation of the law demonstrated a lack of intention to enforce the law).


\(^10\) See id. at 519 n.57 (noting that “straight bank deposits and plain vanilla insurance are not regulated by the new law because they do not have security-like features that could cause their value to drop below par”).

\(^11\) FIEL, Law No. 2 of 1948, art. 27-26 (amended 2006) (Japan) (requiring disclosure by owners of large volumes of shares).

\(^12\) Id. arts. 24-4-2, 24-4-4, 24-4-8, 193-2.

\(^13\) Id. art. 27-2.

\(^14\) Id. arts. 197, 197-2, 207.

\(^15\) FSA DESCRIPTION, supra note 8, at 1.
environment [that encourages investor confidence]; (2) "enhance fairness and transparency in the [Japanese] market"; and (3) "enhance the attractiveness of the Japanese market as an international market." While these objectives could be apropos to any number of countries, the immense amount of personal savings amassed by the Japanese population—over $12 trillion—reveals several things specific to Japan. First, large portions of domestic portfolio assets are notably not at work in the Japanese stock and financial exchanges. One likely reason is a lack of confidence in those markets, of which Japanese policy makers have a uniquely strong motivation to bolster such market confidence. Second, given the recent volatility within the global economy, from which Japan's financial markets have certainly not been immune, the FIEL's objectives become all the more pressing.

The FIEL fits comfortably within a global trend of corporate-governance and transparency legislation, with the United States' Sarbanes-Oxley Act of 2002 (SOX) being at least the forerunner and, occasionally, a blueprint for

---

16 Id.
18 A March 2006 analysis of the financial assets of Japanese and U.S. households revealed that, while Japanese financial portfolios placed only 18.5% of assets in stocks, bonds, mutual funds, trusts, and the like, a very sizable 50.9% of personal assets were held in cash and deposits—this stands in stark contrast to corresponding asset-distribution figures in the United States of 53% and 13.3%, respectively. FSA DESCRIPTION, supra note 8, at 1.
19 See Harris, supra note 17, at 20 (citing the hefty personal savings of the Japanese as an incentive to inspire investments).
such international legislation. Indeed, those portions of the FIEL that require corporate executives' certification and reporting of internal controls are popularly known as "Japanese SOX," or more commonly, "J-SOX."

In the wake of the headline-dominating corporate and accounting scandals of Enron and other corporate giants, the U.S. Congress fast-tracked the passage of SOX.\(^\text{23}\) Though many greeted its reforms with praise, there were also those who voiced vehement dissent.\(^\text{24}\) Indeed, for all its intended (and realized) benefits, SOX and its accompanying regulatory regime have not escaped harsh criticism.

Though the specifics of the criticism may differ from that surrounding SOX, the FIEL, much like its U.S. counterpart, continues to be the focus of strong disapproval. However, a law of its scale will inevitably be subject to a period of adjustment, both in the sense of market adjustment to the regulation and, if the Japanese government is so inclined, in making necessary amendments to the regulation to meet pressing market needs.\(^\text{25}\) As Japan transitions from the old laws to the FIEL, it is of primary concern whether, like the mythic Hydra, the FIEL will turn out to be a beast with two heads instead of one. Or, will the great reforms of the FIEL be viewed as a mighty Hercules? Specifically, potential conflict is inherent between the FIEL’s dual aims of strengthening investor protection and re-energizing the market. Nonetheless, the FIEL’s critical revision of outdated securities regulation will most likely deliver long-term benefits, like market stabilization, outweighing short-term implementation and compliance concerns that arise as the law is refined.

Part II of this Note examines several factors that led to the adoption of both SOX and the FIEL, focusing particularly on corporate and accounting...
malfeasance. The perfect storm of factors enabling such market failures as the Enron scandal that led to the call for the SOX reforms has been intensely scrutinized in the years since those events unfolded. As such, the full breadth of those factors will not be belabored here given this Note’s primary focus on the FIEL. Instead, this Note limits its scope to an overview of the principal factors leading to the SOX reforms, viewed primarily through the lens of Enron’s collapse. The exposition of the FIEL in this Note will seek to address the structural, cultural, and political elements unique to the context of the Japanese financial market that were fundamental to identifying the need for regulatory reform.

Part III delves into the substantive provisions of SOX and the FIEL, explicating the commonalities between the laws and also the significant sections of the FIEL that developed beyond the influence of SOX. Part IV concludes with an analysis of the primary praise and criticism of SOX as well as the intended benefits, current criticisms, and projected future of the FIEL.

II. THE ROOTS OF REFORM

A. SOX: Conditions Contributing to the Inevitable Enron Bombshell

A confluence of factors facilitated certain conditions making possible the numerous corporate frauds that besieged U.S. markets in the early part of this century. This multitude of highly publicized frauds, and particularly that at

---

26 See generally John C. Coffee, Jr., What Caused Enron? A Capsule Social and Economic History of the 1990s, 89 CORNELL L. REV. 269 (2004) (discussing the multi-faceted origins of the Enron scandal and dismissing explanations such as an increase in corporate greed or that scandals are cyclical and inevitable).

27 For an in-depth discussion of Enron’s collapse, see generally Jeffrey D. Van Niel, Enron—The Primer, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 3 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

28 In 2004, Senator Paul Sarbanes, one of the legislators who drafted SOX and after whom SOX is named, stated:

The Senate Banking Committee undertook a series of hearings on the problems in the markets that had led to a loss of hundreds and hundreds of billions, indeed trillions of dollars in market value. The hearings set out to lay the foundation for legislation.

. . . .

The hearings produced remarkable consensus on the nature of the problems: inadequate oversight of accountants, lack of auditor independence, weak corporate governance procedures, stock analysts’ conflict of interests [sic], inadequate disclosure provisions, and grossly inadequate funding of the Securities and Exchange Commission.
Enron, brought such factors fully to light and made clear the necessity for regulatory reform. When all was said and done, Enron, which by the year 2000 had grown to be the sixth-largest energy company in the world, became the largest company in U.S. history to declare bankruptcy. The impact on U.S. markets from Enron, compounded by numerous similar corporate scandals, was truly seismic.

Without doubt, Enron’s corporate executives, including Kenneth Lay and Jeffrey Skilling, shoulder a sizeable share of the blame. Ironically, however, among the factors leading to the corporate corruption that was the impetus for Congress’s SOX reforms were various deregulatory initiatives taken by Congress in the mid-1990s. For example, the effect of the Private Securities Litigation Reform Act of 1995 (PSLRA) was to make it “harder for defrauded investors to sue [violating companies] in the United States.” Moreover, “[s]tudies have shown that the PSLRA [and other deregulatory acts] enabled an environment that almost invited the fraud that spun out of control in the corporate fiascos of Enron” and others.

An additional factor is identified in the SOX reforms’ emphasis on greater oversight of auditors and corporate management, which speaks to the...

---


36 For example, Title I of SOX creates the Public Company Accounting Oversight Board (PCAOB). Sarbanes-Oxley Act (SOX) of 2002 § 101, 15 U.S.C. § 7211 (2006). See also Public
insufficiency of such oversight pre-SOX. Indeed, “[w]hile there will always be wrongdoing, one of the great failures during this period was the failure of ‘gatekeepers’ to fulfill their responsibilities.”

1. Lack of Auditor Independence

One of the gatekeepers to fail in the Enron debacle was the company’s auditing firm, Arthur Andersen. To avoid conflicts of interest that could compromise the integrity of an audit, such firms ought to remain independent of the client company. This safeguard was distinctly lacking in the Enron-Arthur Andersen relationship.

In addition to providing Enron with auditing services, Arthur Andersen also realized significant profits by providing Enron with consulting services that largely consisted of advising Enron on the structuring of business deals. Obviously, an accounting firm’s audit client serving as a significant source of revenue for additional services suggests a potential conflict of interest. Further, the “consulting fees may also have been lucrative enough to deter Andersen from asking Enron to make revisions to its financial statements.”

2. Weak Corporate Governance and Ethics

Another set of gatekeepers to fall short of its obligations was Enron’s board of directors and the company’s audit committee. Though both Enron’s board and its audit committee appeared to be gold standards, they both tarnished


38 See id. at 526–30 (giving a description of a specific questionable Enron transaction in which Arthur Andersen was complicit).

39 Id.

40 Andersen received $52 million from Enron in 2000, with approximately half ($25 million) for audit services and the remainder ($27 million) for consulting services. Van Niel, supra note 27, at 17.

41 See id. (“Andersen’s extensive consulting work for Enron may well have compromised its independence and its judgment in determining the nature, timing, and extent of audit procedures.”).

42 Id. (“Andersen estimated that keeping Enron as a client would generate $100 million a year in revenues.”).

43 Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information
that standard significantly. Moreover, corporate wrongdoing such as that at Enron is, by its nature, fraught with ethical violations. Several examples from the Enron context, described below, flesh out the laissez-faire approach of the board and audit committee as well as the obviously lower priority given to maintaining ethical standards.

First, Enron utilized stock options in order to maintain high levels of compensation for its executives. This created two significant issues: “[T]he interaction of Enron’s high-powered stock-based compensation structure, [and] the corresponding managerial temptation to manipulate financial results that would affect the stock price . . . created an unusual risk that should have called forth unusual, intense Board monitoring of business results and financial controls.” Such scrutiny by the board, however, did not occur. Additionally, in issuing stock-option grants to its executives, Enron did not treat such grants as a form of compensation and, thus, did not list the grants as expenses. “Though not illegal, this practice allows the posting of financial data that is not complete, especially in Enron’s case, where stock options represented a very large and important form of employee compensation.”

Further, Enron utilized exceedingly complicated and opaque financial reports, making it virtually impossible to diagnose the company’s financial health, even for trained analysts. Given this complexity, one would expect Enron’s audit committee meetings to be incredibly detailed in order to provide a thorough analysis of the company’s activities. However, while meeting agenda may have outlined a broad scope and depth of detail, it appears from actual meeting minutes that the committee “was merely going through the

---

*Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1127 (2003) (“[T]he Enron Board was composed largely of outside directors, who were apparently independent and competent. The audit committee, which operated under a state of the art charter, was chaired by a Stanford Business School accounting professor.”).

44 *Id.* at 1129–30; *see also* Van Niel, *supra* note 27, at 16 (“The use of stock option grants . . . actually started as a reaction to a $1,000,000 cap on salaries for top-level employees.”).


46 *Id.*


48 *Id.* (“Had Enron reported the granting of stock options in the manner proposed by the Financial Accounting Standards Board (FASB), Enron’s profits from 1998 through 2000 would have been reduced by approximately $188 million.”).

Finally, decisions by Enron executives caused unbearable losses to Enron employees, whose 401(k) pension plans went into a thirty-day "blackout period during which plan participants were prohibited from making inter-fund transfers within the 401(k) plan." Supposedly, Enron made its decision to change its 401(k) plan administrators, which caused the thirty-day blackout period, well before announcing it. However, the timing seems particularly suspicious—during the thirty-day period, "[w]hile Enron executives were dumping all of their Enron stock, rank-and-file plan participants could only watch in horror as their life savings disappeared.

The above "examples of director dereliction in Enron... evidence little desire to call colleagues to account and certainly do not inspire confidence that the board of directors will keep a watchful eye on management." The above factors led to the enactment of SOX via the unfortunate route of numerous corporate debacles, to the detriment of countless investors. A series of factors in the Japanese context paved the way for the FIEL through a similar path of corporate scandals.

B. The FIEL: Structural, Cultural, and Political Factors in Japan, and the Inevitable Livedoor Bombshell

When taken in historical context, the influence of a foreign law like SOX on the development of the FIEL should come as no surprise, as a number of

50 See Murdock, supra note 37, at 533 (setting forth a reproduction of such an agenda and noting that "[t]he fact that the audit committee spent so little time on so many matters of great magnitude suggests that it was merely going through the motions").


52 Thomas, supra note 49.

53 Id.


55 Murdock, supra note 37, at 537. Murdock goes on to state that "the dominant thrust of judicial decisions [dealing with such corporate wrongdoing] is essentially blind deference to boards of directors. If there is no one looking over your shoulder, why worry?" Id.
Japan's foundational corporate laws are rooted in foreign-law transplants. A prime example is Japan's original Commercial Code,\(^5\) "imported" from Germany in the late nineteenth century\(^5\) as part of the Meiji\(^5\) legal reforms. Further foreign law influence came from the U.S. occupation of Japan following World War II, during which time the corporate law was amended\(^5\) to be more in line with U.S. corporate law.\(^5\)

Likewise, during the same postwar occupation period, the FIEL's predecessor, the Securities and Exchange Law, assumed its role as Japan's fundamental securities law.\(^6\) The Securities and Exchange Law was directly modeled after U.S. federal securities statutes\(^6\) and "thus, at least in form, reflected the classic . . . thesis underlying Anglo-American corporate governance: the notion that widely dispersed shareholders (perceived as inevitable) cede effective control of their firm to professional managers via an agency relationship with independent directors."\(^6\) However, despite U.S. efforts to create an "economic democracy"\(^6\) through regulatory changes like those mentioned above, the hoped-for shift to such an ideal never materialized in Japan in the remaining fifty years of the twentieth century.\(^6\) Nonetheless, such a result had little impact on Japanese economic activity during much of


\(^6\) Curtis J. Milhaupt, *Historical Pathways of Reform: Foreign Law Transplants and Japanese Corporate Governance*, in *CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US* 53, 53-55 (Klaus J. Hopt et al. eds., 2005). "[The code's] basic structure and characteristics—the prescription of detailed capital requirements and strong shareholder control rights over corporate decisions—reflect this German origin." Id. at 55.


\(^6\) Milhaupt, *supra* note 57, at 55. The amendments "principally . . . strengthen[ed] perceived weaknesses in minority shareholder rights and 'corporate democracy', but these amendments arguably added to, rather than relaxed, the code's rigidities." Id. Indeed, the revised law was "surprisingly paternalistic, archaic and impractical"—for example, the law prohibited, with few exceptions, corporate stock repurchases and limited the type of equity a company could issue. Id. at 55-56.

\(^6\) Id.

\(^6\) Stuber et al., *supra* note 2, at 457 n.95.


\(^6\) Stuber et al., *supra* note 2, at 457 n.95.

\(^6\) Id.

\(^6\) Id.
that same fifty-year period.\textsuperscript{66} An exploration of factors underlying Japan’s delayed acceptance of foreign market practices is pertinent to an understanding of its simultaneous realization of postwar economic growth.

These fundamental factors can be divided into three primary, though non-exclusive, categories: structural, cultural, and political.\textsuperscript{67} In order to develop these factors with clarity, it is prudent to examine their development in context. As previously stated, an integral motivating force behind the FIEL was a determination to “enhance the attractiveness of the Japanese market as an international market,” or in other words to encourage foreign direct investment (FDI).\textsuperscript{68} Such a push for FDI is not a new development. Indeed, the FIEL is in stride with a trend of FDI growth that Japan has seen since the 1990s.\textsuperscript{69}

Moreover, with growth in FDI comes a correlative increase in mergers\textsuperscript{70} and acquisitions\textsuperscript{71} (M&A) and tender offer bid\textsuperscript{72} (TOB) activity. One need look no further than the FIEL’s provision on TOBs\textsuperscript{73} for evidence that the law’s drafters addressed such a connection between a rise in this sort of activity and an increase in FDI. Thus, looking through the lens of a marked rise in M&A, TOB activity is\textsuperscript{74} an ideal means by which to comprehend the structural,  

\textsuperscript{66} Yoshiro Miwa & J. Mark Ramseyer, Asking the Wrong Question: Changes of Governance in Historical Perspective?, in CORPORATE GOVERNANCE IN CONTEXT, supra note 57, at 73, 74 (“In 1970 prices, the gross national expenditure climbed from 16.8 billion yen in 1955 to 40.9 billion in 1965 and 92.0 in 1975—quintupling in 20 years. From 1975 to 2000, real wages climbed by nearly a third yet again. In 1870, per capita real GDP in Japan was 85% of the world average. By 1998, that figure had climbed to 358%—behind the US (479%) but beyond France (343%), Germany (312%), and the UK (328%).”).

\textsuperscript{67} See ENRICO COLCERA, THE MARKET FOR CORPORATE CONTROL IN JAPAN: M&AS, HOSTILE TAKEOVERS AND REGULATORY FRAMEWORK 4 (2007) (listing other factors as well).

\textsuperscript{68} FSA DESCRIPTION, supra note 8, at 1.

\textsuperscript{69} See Political Factors discussion infra Part II.B.3.

\textsuperscript{70} Colcera defines a merger as the “process through which two different and autonomous companies join together and become a sole juridical and economic entity,” and can take the form either of one company absorbing the other or, alternatively, of the two merging companies combining to form into a new corporation. COLCERA, supra note 67, at 5.

\textsuperscript{71} An acquisition is a transaction through which “‘one firm, A, pays for all the assets or all the stock of another, B.’” Id. at 7 (quoting D.A. OESTERLE, THE LAW OF MERGERS AND ACQUISITIONS 1 (1999)).

\textsuperscript{72} A tender offer bid is also known as a “takeover” bid. A takeover, at least in a stock purchase context, is a “‘stock purchase offer in which the acquiring firm buys a controlling block of stock in a target, most often a majority of the outstanding voting stock. The controlling block of stocks enables the purchasing firm to elect the target’s board of directors and to effect . . . mergers.’” Id. (quoting OESTERLE, supra note 71, at 3).

\textsuperscript{73} See discussion infra Part III.B.

\textsuperscript{74} Indeed, in 2005, Japan’s M&A market growth was the most active in the world, surpassing even the United States, the United Kingdom, and Australia. Marcelo Bombau et al.,
cultural, and political factors affecting Japan’s delayed acceptance of foreign market practices.

1. Structural Factors

A key driver of Japan’s dynamic postwar economic growth was a network of various corporate relationships centered around a “main bank.” Given the challenges inherent in a post-war recovery, “[t]he old model was well suited to the times: it delivered social stability and cohesion as Japanese workers pulled together to catch up with Western nations, and helped Japan to become the world’s second-biggest economy.”

The roots of the old model can be traced back to the pre-war zaibatsu—holding companies which had controlling interests in a group of firms, “many of which, in turn, had controlling interests in other firms.” By imposing an anti-monopoly statute, the Allied Forces dissolved the zaibatsu following World War II in order to “introduce ‘Western’ principles of corporate democracy and to dismantle the industrial underpinnings of Japanese militarism.” However, subsequent amendments to this anti-monopoly statute resurrected the possibility for cross-shareholding between firms.

Indeed, it was those reciprocal cross-, as well as stable, shareholdings that served as the foundation for the strength of the symbiotic network of postwar corporate relationships. Effectively, cross-shareholding is, as its name suggests, two or more companies that hold shares in one another, though the ratios of shareholding may not necessarily be balanced. Stable shareholding,
in contrast to cross-shareholding’s consideration only of the mutual shareholding relationship, also “considers . . . one-sided holdings of financial institutions and listed affiliated companies, which retain companies’ shares for a specific, long period of time.”

Thus, despite the nomenclature, both types of shareholdings provided their own forms of stability for participating companies by limiting the number of shares available on the market and “insulat[ing] the management of both sides from any market threat of hostile takeover.”

Responding to U.S. criticism, Japan’s Economic Planning Agency, gave a similar justification for the practice of cross-shareholding in 1992, laying out its reasoning in three parts:

a) cross-shareholdings ensure that stable partners and stable investors are able to buy newly issued stocks whenever necessary, and so they represent a secure source of funding;

b) cross-shareholdings eliminate the threat of hostile takeovers, therefore allowing the management to pursue long-term plans;

c) cross-shareholdings stabilize and reinforce business relations between companies.

When examining cross-shareholding in the Japanese context, one cannot avoid the related concept of keiretsu. In short, keiretsu are integrated corporate conglomerates operating under a concept encompassing characteristics of both cross- and stable shareholding. A more extensive definition, however, has been offered by the Japan Export Information in France, which are comprised of related companies, cross-shareholding in Japan consists of unrelated companies, thereby “giving each company greater incentive to monitor the other companies to prevent the rise of an absolute power in the group.”

Colcera, supra note 67, at 77 (internal citation omitted) (“Even when [shares] are traded, the shareholding level is immediately reconstituted through a new repurchase of shares which leaves the stable shareholding ratio intact in the market.”).


Colcera, supra note 67, at 75.

See id. (noting that “[i]n the Japanese context, cross-shareholding is intrinsically linked with another well-known concept: keiretsu”).

The six major postwar keiretsu were Mitsubishi, Mitsui, Sumitomo, Fuji, Sanwa, and Daichi. Id. at 78. The breadth of the companies making up these groups is exemplified by the Fuji keiretsu, which was centered around Fuji Bank until 2000, and Mizuho Bank thereafter, and consisted of Canon, Hitachi, Marubeni, Matsuya, Nissan, Ricoh, Tobu Railway, and Yamaha.
Center. Though many accept *keiretsu* as a recognized element in the historical structure of Japanese corporate relationships, some renowned scholars do not subscribe to its existence. Yet, regardless of the debate surrounding the existence of *keiretsu*, the effect of cross- and stable shareholdings was to block sizeable chunks of Japanese stock from being available in the market, with such stock instead being “retained by financial institutions or business corporations, affiliates or partners, and . . . therefore seldom traded.” Given that “[t]he purpose of most cross-shareholding is to avoid rather than confer shareholder rights, . . . stable shareholding relationships function as a strategy of corporate management to limit shareholder governance of the firm.” Thus, with shareholder governance acting as the motor behind M&A and TOB strategies, cross- and stable shareholdings posed a substantial structural barrier to cross-border M&As or TOBs.

Japan’s meteoric postwar economic rise peaked in the late 1980s. Equally famously, the bubble economy that had been propping up Japan’s growth burst resoundingly in 1992. Thereafter, Japan’s economy entered a period of extended recession, often referred to as the “lost decade.” There are a number

---

87 The definition states:

Keiretsu, or integrated corporate groupings, are a structural arrangement of Japanese firms that are characterized by close business relationships intertwined with long/term [sic] commitments among their members. Keiretsu firms are tied in with one another through cross-shareholdings, long-standing buyer-supplier arrangements, interlocking directorates, the exchange of personnel among member firms, access to credit and marketing channels, management ties through presidents’ clubs, and the sharing of information concerning product development and distribution.


89 COLCERA, supra note 67, at 81.

90 Discussion Paper, supra note 77, at 2.


92 Small, supra note 1, at 347.

93 *Id.* at 347–48. In the days following record losses across U.S. stock markets in 2008, U.S. media outlets began recalling Japan’s “lost decade,” questioning if the United States is headed for a similar fate. See, e.g., Anthony Faola, Studying Japan’s Dark Decade to See How U.S. Might Fare, WASH. POST, Oct. 11, 2008, at A13 (concluding that, if Japan’s experience is any guide, fears of a current U.S. recession resembling “Depression-era soup lines . . . [m]ay be out
of contentious views regarding the circumstances that led to Japan’s economic collapse.\textsuperscript{94} While a debate over the causes of Japan’s asset bubble and its collapse are beyond the scope of this Note, it is worthwhile to note that the complex variety of elements that fueled Japan’s meteoric postwar economic growth could no longer keep pace with the less-rigid modern models\textsuperscript{95} in use outside Japan.\textsuperscript{96}

Since the 1990s, significant portions of formerly held cross- and stable-held stocks have been released into the market. Specifically, the level of cross-shareholding value ratio decreased from 18.4\% in 1987 to 7.4\% in 2002, a decline of almost 60\% in that fifteen-year period.\textsuperscript{97} Similarly, the level of stable shareholding value ratio reached 27.1\% in 2002, down from 45.8\% in 1987, representing a more than 40\% decline.\textsuperscript{98} These formerly cross- and stable held stocks are increasingly being purchased by foreign and individual investors.\textsuperscript{99} Such market activity is clearly moving in the direction of the FIEL’s objectives, facilitating the momentum of such a trend squarely in the sights of the statute.

\textsuperscript{94} Two common views are that (1) deregulation of aspects of the financial markets in the 1980s made it possible for firms to access funding from sources other than their banks, causing banks to supplement lost borrowers with high-risk loans that then failed; and (2) the same deregulation made it possible for keiretsu firms to shift away from the monitoring and disciplining of their main banks and speculate in the developing bubble, which then burst. Miwa & Ramseyer, supra note 66, at 150. After introducing these explanations, Miwa and Ramseyer reject the validity of both. \textit{Id.}

\textsuperscript{95} Examples of tools available under such less rigid models include “stock options and innovative organization and contractual mechanisms not available under Japanese law.” Milhaupt, supra note 57, at 57.

\textsuperscript{96} In 2001, the State Department, in reporting on FDI in Japan to President George W. Bush, stated that the Vice Minister for International Affairs [of Japan’s Ministry of Economy, Trade and Industry] Hidehiro Konno described . . . the changes taking place in [Japan’s] economy— for example, the unwinding of cross-shareholding and introduction of global accounting standards— but emphasized that there is a growing realization that Japan’s post-war economic system “has outlived its usefulness.” [Minister Konno] stressed that the Japanese Government is committed to economic structural reform, which aims at making Japan’s business environment more attractive internationally as well as domestically.


\textsuperscript{98} \textit{Colcera, supra note 67, at 83.} Colcera uses the terms “stable shareholdings” and “long-term holdings” interchangeably. \textit{Id.}

\textsuperscript{99} \textit{Id. at 84.}
2. Cultural Factors

Any examination of cultural factors inevitably runs the risk of slipping into generalization or, worse, caricature. Yet, as exemplified by Japan’s postwar shift to an altered version of the pre-war zaibatsu, the effect of cultural views on how corporations should operate and interrelate is undeniable. As such, an exploration of the impact of cultural views in Japan on M&A and TOBs is warranted.

In the 1970s and 1980s, reluctance toward M&A and TOBs remained strong in Japan.\(^{100}\) Among small- and medium-sized firms, and particularly among entrepreneurs, the acquisition or merging of one’s company had a strong association with failure.\(^{101}\) Similarly, larger blue-chip companies viewed M&A and takeover activity as unacceptable business practices.\(^{102}\) The director of one Japanese company explains, “In Japan, acquisition is often perceived as a company hijack, and people tend to feel guilty when they sell or buy companies.”\(^{103}\)

Such an attitude is markedly different from that held in the United States, opening the door for a significant breakdown of intercultural communication: “[W]hen a foreign company approaches a Japanese candidate for a potential M&A deal, the prospective Japanese firm will be upset or offended at first.”\(^{104}\) Given this reality, the chances of a successful cross-border M&A or TOB are significantly enhanced if a foreign firm develops beforehand an effective negotiation style and a long-standing and trusted relationship with the Japanese firm.\(^{105}\) As such, broaching negotiations with a Japanese firm “will require much time and patience.”\(^{106}\)

By the 1990s, Japanese attitudes toward M&A and TOBs had become more accepting. A 1990 survey found that 80% of the presidents of leading listed companies were open to using M&A as a means of expanding their business and distribution network.\(^{107}\) In a 1998 survey, 84.7% of respondents at large companies said “M&A is an important business strategy,” with only 6.9%
expressing “reservations about M&A.” Particularly telling of a shift in perspective are the results of two 2005 surveys of top executives, which revealed not only that “nearly 30% of the leading companies were setting aside large sums for [M&A],” but also that “64.8% (of [Nikkei Business Daily] online readers) support[ed] the notion that hostile takeovers can be positive, depending on who the acquiring entity is.”

Such data makes unmistakably clear that the landscape of Japanese cultural views toward M&A and TOB activity has dramatically changed. Replacing a sense of shame formerly associated particularly with cross-border M&A and TOB, Japan exhibits “[a] culture that generally does not now distinguish between foreign and domestic players . . . [and] does not necessarily require the existence of long and well-established business relationships between the parties in the deal . . . [or] any exceptional style of negotiation.” This current cultural perspective would appear to provide fertile ground for the realization of the FIEL’s FDI objectives.

3. Political Factors

During the postwar period, changes to Japanese corporate law were both rare and slow to take effect. Moreover, such revisions rarely responded to market needs, and were more “policy pushed” than “demand pulled.” However, this trend changed in 1997, when the corporate community successfully lobbied for an amendment to the Commercial Code that would permit the issuance of stock options. Thus, politicians, legal scholars, and business people now work closely together.

Rather than being simply a random consequence of the Japanese economic crisis, the increase in the number of M&A is the result of strategic efforts by political and economic Japanese institutions. The Japan Investment Council was the first to promote FDI, and thus cross-border M&A, in the mid-1990s.

---

108 See id. (noting that those surveyed were “Japanese business operators and big companies”).
109 Id. (emphasis added).
110 Id. at 74.
111 Id.
112 Milhaupt, supra note 57, at 57.
113 Id. (citing Zenichi Shishido, Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective, 49 AM. J. COMP. L. 653 (2001)).
114 Id. Interestingly, the FIEL stands in contrast to this trend. Given its objective of changing the course of Japanese markets in the wake of corporate scandals, it appears to be at least equally, if not more, “policy pushed.” Id.
115 COLCERA, supra note 67, at 40.
116 Id. at 88.
The Council, formed by the Japanese government to encourage investment and revitalize the nation's economy, stated in no uncertain terms that it "welcomes M&A in Japan, and declares that it will spare no effort in helping foreign companies with M&A."\(^\text{117}\)

Another similarly focused, government-related organization is the Japan External Trade Organization (JETRO). JETRO's organizational description further exemplifies Japan's shift to a policy of facilitating FDI: "Originally established in 1958 to promote Japanese exports abroad, JETRO's core focus in the 21st century has shifted toward promoting foreign direct investment into Japan . . . ."\(^\text{118}\) In a preliminary effort toward that end, JETRO released a prospectus listing nine legislative acts passed between 1996 and 2001 that significantly impacted Japan's market for M&A.\(^\text{119}\)

Beyond legislative acts, Japan's executive leader has also played an important role. Prime Minister Junichiro Koizumi proclaimed the Program for the Promotion of Foreign Direct Investment in Japan, which "aimed at doubling the FDI stock by 2008."\(^\text{120}\) Further, in June 2001, U.S. President George W. Bush and Japanese Prime Minister Koizumi launched the U.S.-Japan Economic Partnership for Growth.\(^\text{121}\) The U.S.-Japan Investment Initiative was launched in conjunction with this partnership, "provid[ing] an important mutual forum to explore ways to remove barriers through exchanges of opinion on key issues such as measures to improve investment conditions in both the United States and Japan."\(^\text{122}\) One primary focus of the initiative is the "facilitation of cross-border M&A."\(^\text{123}\)

\(^\text{117}\) Id. at 89.
\(^\text{119}\) COLCERA, supra note 67, at 89. These legislative acts include:

1) the relaxation of the standards of creditworthiness for corporate bond issuance made it easier to secure funds for use in M&A (1996); 2) the simplification of the procedural requirements for mergers (1997); 3) the elimination of the ban on pure holding companies (1997); 4) the relaxation of the standards for merger reporting (1999); 5) the introduction of a stock swap and transfer system (1999); 6) the enactment of the Industrial Revitalization Law (1999); 7) the enactment of the Reorganization Bankruptcy Law (1999); 8) the changeover to consolidated accounting (1999); and finally, 9) the introduction of a corporate breakup system (2001).

\(^\text{120}\) Id. at 90.
\(^\text{122}\) Id.
\(^\text{123}\) Id.
As the most recent piece of legislation addressing the issue, the FIEL fits naturally in Japan’s decade-long commitment to facilitating FDI. However, its effects remain to be seen.

4. Livedoor

In early 2005, the Livedoor saga became “[o]ne of the most dramatic corporate takeovers in Japanese business history,”\(^{124}\) attracting widespread public attention.\(^{125}\) The “clash between the old and new Japanese business cultures” made the unfolding story particularly riveting.\(^{126}\) Livedoor, a “young internet startup firm”\(^{127}\) with a brash entrepreneur for its president,\(^{128}\) pitted itself against Nippon Broadcasting System (NBS), the “largest shareholder of the old-line media conglomerate, Fuji Television Network.”\(^{129}\)

Livedoor utilized an unconventional, though technically legal, takeover method in which it “amassed its stake in NBS by taking advantage of a loophole in Japan’s Securities and Exchange Law that allowed it to buy NBS shares electronically, after the trading floors had closed,”\(^{130}\) which “therefore exempted [it] from triggering the mandatory tender offer procedures under Japanese law.”\(^{131}\) When Livedoor announced that it had acquired approximately 35% of NBS’s shares, and therefore a comparable percentage of its voting power, NBS and Fuji instituted several waves of defensive measures.\(^{132}\)

First, Fuji moved on its existing tender offer,\(^{133}\) seeking to acquire at least 25% of NBS’s shares.\(^{134}\) Fuji made this move in order to take advantage of a Japanese commercial law that would prevent Livedoor from exercising voting rights in any Fuji stock owned by NBS should Livedoor succeed in its

\(^{124}\) Bombau et al., *supra* note 74, at 326.
\(^{126}\) *Id.*
\(^{127}\) Bombau et al., *supra* note 74, at 326.
\(^{129}\) Bombau et al., *supra* note 74, at 326.
\(^{130}\) *Id.*
\(^{131}\) Yamanouchi & Jones, *supra* note 125.
\(^{132}\) *Id.*
\(^{133}\) Gruener, *supra* note 128, at 878.
\(^{134}\) Yamanouchi & Jones, *supra* note 125.
NBS-takeover attempt. In response, Livedoor continued purchasing NBS shares, eventually amassing a 50% stake.

NBS and Fuji then implemented a more drastic defense in which NBS planned “to issue equity warrants to Fuji in order to dilute Livedoor’s stake in NBS.” Livedoor quickly filed a petition to enjoin the sale of these warrants, which the Tokyo District Court then granted.

Less than two months after it announced its original acquisition of NBS shares, Livedoor succeeded in purchasing a majority interest in NBS. In a final move to avoid Livedoor’s interference with management of Fuji via NBS, Fuji had NBS “loan[ ] the shares it held of Fuji TV to Softbank Investment for five years, during which period [NBS] would not be able to exercise the voting rights of such shares in Fuji TV.” In the face of this development, Livedoor’s best option was to “seek a truce with Fuji TV . . . . Livedoor sold its entire stake in NBS to Fuji TV at a slight profit, and in return Fuji TV invested around $440 million in Livedoor and agreed to establish a business alliance.”

However, this was only the first stage of events and the truce would prove to be short-lived. The dramatic denouement came in early 2006, when Livedoor’s top executives were arrested and indicted following a months-long secret investigation by Japan’s Securities and Exchange Surveillance Commission. This sent Livedoor’s stock price into a tailspin, leading Fuji to sell its stake in Livedoor. Further, the company was delisted from

---

135 Id.
136 Id.
137 Bombau et al., supra note 74, at 326.
138 Yamanouchi & Jones, supra note 125. The court’s decision signaled the growing acceptance, addressed above, of such takeover attempts. However, the ruling did not leave target companies without a defense as it “alerted corporate management that defensive measures should be introduced well in advance of the arrival of an unwelcome acquirer.” Id.
139 See id. (noting Livedoor’s original offer came in late January, and it acquired a majority of NBS shares by March).
140 Id.
141 Gruener, supra note 128, at 880.
142 Bombau et al., supra note 74, at 326. “Prosecutors believe Livedoor fraudulently reported a consolidated pretax profit of 5.03 billion yen in the year ended [sic] September 2004 by booking fictitious sales, although it actually incurred a pretax loss of 312.78 million yen.” Id. at 326 n.60 (emphasis added).
143 Id. at 326 n.61 (“Livedoor lost nearly 90% of its trading value in the two months following the January indictments . . . . Meanwhile, the Nikkei 225 Stock Average tumbled 5.7% [with]in just two days of the Livedoor sell-off, prompting the TSE [Tokyo Stock Exchange] to suspend all trading on January 18, 2006—the first early close in the TSE’s 57-year history.”).
144 Id. at 326. “For its 2005 fiscal year, Fuji . . . claim[ed] a 34.5 billion yen loss on the sale,
the Tokyo Stock Exchange.\textsuperscript{145} Due to securities law violations, Livedoor's president received a two-and-one-half year prison sentence on March 16, 2007.\textsuperscript{146} Moreover, on June 13, 2008, the Tokyo District Court "ordered Livedoor Holdings Co. to pay more than 9.5 billion yen to Nippon Life Insurance Co. and five trust banks, all former shareholders . . . , to compensate them for the massive financial loss they suffered following the collapse of the company's share price."\textsuperscript{147} In the end, the "Livedoor-Fuji battle for control of NBS convinced lawmakers to close the loophole in the [Securities and Exchange Law], and also prompted many Japanese corporations to institute potent takeover defenses."\textsuperscript{148}

III. THE HARMONY AND THE DISSONANCE

The vast scope of the FIEL legislation brings truly comprehensive reforms. Like SOX, which applies to all reporting companies including those firms traded on a U.S. stock exchange, the FIEL applies to the approximately 3,800 listed Japanese companies.\textsuperscript{149} Additionally, as the J-SOX provisions of the FIEL apply to each company as a whole, the FIEL's reach will extend to a Japanese company's foreign subsidiaries.\textsuperscript{150}

The J-SOX provisions largely resemble Sections 302 and 404 of SOX. Beyond the J-SOX reforms, however, the FIEL contains other provisions of equal significance. What follows is an examination of the J-SOX provisions, with particular attention to its similarities with and differences from SOX. Thereafter, focus shifts to an analysis of the remainder of the FIEL's significant provisions.

A. Common Ground

Specific parallels are commonly recognized between SOX Section 302 and J-SOX Article 24-4-2, which both require management to sign off on the
accuracy of periodic reports. Additional parallels are drawn between SOX Section 404 and J-SOX Article 24-4-4, which govern internal controls over financial reporting. The pertinent provisions of both pieces of legislation seek to accomplish the same end: to prompt publicly listed companies to guarantee the accuracy and reliability of their financial reports by maintaining internal controls. From this common starting point, each law sets out its own framework for accomplishing the desired ends.

The requirements found in SOX Section 302 and J-SOX Article 24-4-2 compel executives to certify their companies’ reports. This is a simple, yet vital, component of both pieces of legislation because it eliminates the possibility that the heads of public corporations will escape liability for acts of fraud. As opposed to establishing only an executive’s indirect complicity with such acts, these provisions create direct liability.

In essence, under both SOX Section 404 and J-SOX Article 24-4-4, the management of each listed company must “evaluate the internal control over financial reporting . . . of its own company, prepare reports of its conclusions, and be subject to audit by its external auditors.” To provide time for affected

---

151 J-SOX article 24-4-2 went into effect from the fiscal year starting on April 1, 2008. FSA DESCRIPTION, supra note 8, at 18.

152 Internal control has been defined as “a process that is carried out by all members of the company, in order to fulfill four corporate objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reports; (3) compliance with laws and regulations relating to business activities; and (4) preservation of assets.” Financial System Council, Subcomm. on Internal Controls, Bus. Acct. Council, Evaluation and Auditing Standards for Internal Control Reported in Financial Reports, FSA NEWSLETTER (Financial Services Agency, Tokyo, Japan), Feb. 2006, at 15, available at http://www.fsa.go.jp/en/newsletter/2006/02.pdf [hereinafter FSA NEWSLETTER].


154 Dorsey & Whitney LLP, Foreign Private Issuers and the Sarbanes-Oxley Act of 2002, Aug. 2, 2002, available at http://www.dorsey.com/64/Resources/Detail.aspx?pub=29 (“[SOX] Section 906 provides that a CEO or CFO who certifies a report ‘knowing’ that it does not comport with the certification is criminally liable for a fine of up to US$1,000,000 or imprisonment of up to 10 years, or both. If the CEO or CFO ‘willfully’ certifies the report ‘knowing’ that it does not comport with the certification he or she is liable for a fine of up to US$5,000,000, or imprisonment for up to 20 years, or both.”).}

companies to make the necessary internal changes, the SOX requirements were implemented in phases based on company size. In contrast, Japanese traded companies, regardless of size, were all subject to the same implementation date: the fiscal year beginning April 1, 2008.

As companies implement the necessary internal control measures, both SOX and J-SOX recommend a risk-based, top-down approach. Neither SOX nor J-SOX mandate a specific internal control framework; however, both suggest a framework. The U.S. Securities and Exchange Commission (SEC), which is empowered by various provisions of SOX, recognizes an integrated framework called COSO as one of the frameworks adopted by many U.S.-based corporations. J-SOX suggests its own framework, which consists of the COSO framework plus two additional components: preservation of assets, and IT (information technology) support.

It should be noted that when SOX was originally enacted, it recommended a “bottom-up approach” in which “first the data was checked and then the risks were identified.” As this approach was found to be “an unnecessarily
convoluted and time consuming process,” it was subsequently changed.\textsuperscript{163} Based on observation of this experience, Japan adopted a “top-down approach” in order to better streamline auditing procedures.\textsuperscript{164}

Contrasting with SOX, the scope of “J-SOX is limited to internal controls affecting financial reporting.”\textsuperscript{165} However, this limitation is recouped through J-SOX’s broadened definition of “financial reports.” Unlike the definition in SOX, which includes only financial statements and footnotes, J-SOX requires consideration of “certain other financial-related disclosures in public reports, such as financial highlights, shareholders, and the status of stock issued.”\textsuperscript{166}

Among the distinctions between J-SOX and SOX, “the key difference... is that the Japanese financial authorities have provided more advice and information about J-SOX than their U.S. counterparts did about Sarbanes-Oxley.”\textsuperscript{167} Specifically, the Japanese Financial Services Agency (FSA) released guidelines for implementing internal-control mechanisms in a report called Implementation Standards for Evaluation and Auditing of Internal Control over Financial Reporting (the Standards).\textsuperscript{168}

The Standards’ drafting process provides further evidence of lessons learned in Japan from the aftermath of SOX in the U.S. In late November 2006, only five months after the FIEL was passed, the FSA made a ninety-three-page draft\textsuperscript{169} of the Standards available for a one-month period of public comment.\textsuperscript{170} The public’s comments were then evaluated from late December 2006 until the finalized version of the Standards was released in mid February 2007.\textsuperscript{171}

Moreover, the Standards themselves are purposeful in applying the knowledge gained from SOX. For example, the Standards seek to avoid the confusion and excessive burden caused in response to [SOX]... [by] includ[ing]... examples of specific guidance
or judgment [such as] . . . [d]eficiencies detected during the internal control evaluation process should be classified as "material weaknesses" if the effect of a misstatement is greater than 5 percent of consolidated pre-tax income.\textsuperscript{172}

Another key distinction lies in the audit to be conducted by the external auditor of management's evaluation of the effectiveness of the company's internal control for financial reports. While under both SOX and J-SOX, this audit can occur concurrently with the company's financial audit, the content of the internal-control audit has a significant difference.\textsuperscript{173} Under SOX, the auditor must issue an opinion both on the management's evaluation of the effectiveness of internal controls as well as on the effectiveness of the internal controls themselves.\textsuperscript{174} J-SOX does not impose the latter requirement. Presumably, this significant difference is based on insight Japan gleaned by observing the increased costs associated with SOX's expanded audit requirement.\textsuperscript{175} Thus, this would appear to be yet another decision by the drafters of J-SOX to mitigate the burdens of compliance.

The next section leaves behind the common ground shared by J-SOX and SOX and shifts focus to the FIEL's other key provisions.

\textbf{B. Parting Ways}

The FIEL makes fundamental changes to Japan's former legal framework. At the most basic level, definitions of core concepts are expanded. For example, the new taxonomy expands the scope of both "securities" and "derivative transactions."\textsuperscript{176} The former now includes all interests in trusts as well as interests in collective investment schemes,\textsuperscript{177} while the latter is divided

\textsuperscript{172} Id.
\textsuperscript{174} Sarbanes-Oxley Act § 404.
\textsuperscript{175} The average cost of Section 404 compliance for an average company in 2004, the year SOX was implemented, was $4.36 million. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 5 (2006) [hereinafter INTERIM REPORT], available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.
\textsuperscript{176} FSA DESCRIPTION, supra note 8, at 4.
\textsuperscript{177} Id. A "collective investment scheme" is a "newly created concept under the [FIEL]" that is defined as "any scheme under which a person: receives contribution money or similar properties from investor(s); conducts business using such money or properties; and distributes profits or properties arising from the business to investors." Masahiro Ueno, Amendments to the
into three categories: market derivatives trading, over-the-counter derivatives trading, and foreign market derivatives trading. Additionally, a number of different types of firms are brought under the umbrella of “financial instruments firm,” the term used for those entities subject to regulation.

Other provisions of the FIEL regulate “financial instruments businesses,” which are businesses required to register if they are “sales and solicitation” operations of securities and derivative transactions, as well as “investment advisory,” “investment management” and “customer asset administration” services. Further, the FIEL creates more flexible rules for regulation upon entry into the financial instruments business, which is now “dependent on the scope of the firm’s business.” Once registered, a firm must display signs at all branch offices and business offices indicating the types of businesses in which they are engaged. Those firms already engaged in a financial instruments business prior to the law’s enactment were required to change their registration before they could engage in any other type of business.

The number and detail of the regulations governing the sale or solicitation of securities or derivative transactions reveal a distinct concern about improper practices in this area. In addition to the obligation for businesses to post signs, the FIEL includes regulations on business advertisements. Additionally, once proper securities sales have been successful, the firm is obligated to deliver written documents before and also at the time of contracting.

Underlying all of these requirements are two general principles: good faith and appropriateness. The prohibitions on conveying false information and conducting either unwanted or excessive solicitation reflect the concern for

---

178 FSA DESCRIPTION, supra note 8, at 7.
179 Id. at 3. Those types of firms so incorporated are securities firms, commodity funds sales firms, investment advisory firms, financial futures trading firms, trust beneficiary rights sales firms, and investment trust management firms. Id.
180 Id. at 5.
181 Id. at 6. Financial instruments businesses are categorized into four categories: the “first financial instruments business” (comprised of “[s]ales and solicitation of securities with high liquidity, customer asset administration, etc.”); “investment management business”; “the second financial instruments business” (comprised of “sales and solicitation of securities with low liquidity, etc.”); and “investment advisory and agency business.” Id.
182 Id. at 6–7.
183 Id. at 6.
184 Id. at 7.
185 Id.
good faith. The principle of appropriateness is expressed through the stipulation that “[i]n light of customer knowledge, experience, and assets, . . . firms must not engage in inappropriate solicitation that may result in insufficient investor protection.”

As a caveat to the above regulations, much of the FIEL’s “appropriateness” regulation is applied contingent on the level of customer knowledge and experience; likewise, the nature of certain obligations (e.g., delivery of documents before contracting) will not be applied if a customer is a “professional investor.” In keeping with the FIEL’s aim of enhancing market attractiveness, “in order to promote financial innovation through the sound development of . . . collective investment schemes . . ., a financial instruments firm is not required to register . . . businesses related to funds dealing with professional investors.”

Additionally, in keeping both with the sales regulations stated above and the FIEL’s aim of developing public confidence in the market, the Financial Products Sales Law is amended by the FIEL to create an enhanced duty for firms to explain the risks of particular types of financial instruments. The amended law imposes strict liability on “a financial instruments firm [that] fails to provide necessary explanation upon sales of a financial instrument,” making it liable for damages. Moreover, “any losses incurred on the principal [are] presumed as losses to be compensated.” To further the goal of boosting public confidence, the FIEL also authorizes the Japanese government to certify organizations that settle complaints and mediate disputes against financial instruments businesses.

As stated above, the FIEL was drafted in recognition of a trend of TOB growth in Japan. In line with the FIEL’s objective of strengthening investor protection, the primary purpose of a TOB system is to impose “duties to disclose information including offer periods, volume and prices [on] companies intending to conduct large volume off-exchange purchases of stock.” This is to ensure “a fair opportunity for shareholders of the target company to sell

---

186 Id.
187 Id.
188 Id. at 8.
189 See discussion supra Part I.
190 FSA DESCRIPTION, supra note 8, at 8.
191 Id. at 10.
192 Id.
193 Id.
194 Id. at 11.
195 Id. at 13.
such stock.” As such, the TOB system under the Securities and Exchange Law has been significantly affected by the FIEL’s legislative revision.

Revisions to laws governing TOB cover a range of issues. For instance, the period for acceptance or withdrawal of a tender offer is expanded to between twenty and sixty business days instead of the former calendar date basis. Further, whereas the withdrawal of TOBs was formerly permitted only in limited cases, now if target companies “take countermeasures against the takeover, offering companies may withdraw tender offers and reduce offering prices.” Perhaps in response to TOBs like those in the Livedoor episode, “aggressive buying involving transactions executed on and/or off the market that will result in shareholdings of one third or more will be subject to regulations on tender offers.” Finally, evidencing an effort to encourage TOBs by “ensur[ing] fairness amongst bidders, if a party with shareholdings of more than one third of the target company’s shares begins a rapid buy-up while a tender offer of another party is in place, the former is obliged to make a tender offer also.”

The FIEL also extends its revision of the Securities and Exchange Law to the reporting system for large shareholdings. This reporting system generally requires a shareholder with greater than 5% of total shareholdings in a listed company to “submit a ‘report on large shareholdings’ within 5 business days from the date of the purchase.” In stark contrast to the former reporting system, under the new system for institutional investors, “the deadline [for this report] will be shortened and the frequency for reporting will be increased to ‘roughly every 2 weeks, within 5 business days.’”

Finally, the FIEL imposes stricter penalties against unfair trading practices. The new regulations effectively double the length of maximum prison sentences and the amount of fines. Particular attention is paid to misegyoku,
or "market manipulation whereby dummy orders are placed to create an impression of active trading that will later be cancelled immediately before the transactions are completed."

Under the FIEL, the scope of civil and criminal penalties is enlarged, as both now apply to misegyoku by customers through securities firms as well as to misegyoku by securities firms as part of self-dealing activities.

IV. THE ROAD AHEAD

Having viewed the legislative history and integral components of SOX and the FIEL, it is only natural to shift focus to what followed the statutes' passage. In particular, both statutes have been subject to their share of criticism. As noted below, despite these criticisms, SOX has delivered some significant benefits. Given its more recent vintage, however, the FIEL has had less opportunity to produce such benefits. Therefore, predicting the FIEL's future impact may be possible by using various post-passage developments as a springboard.

A. SOX: Criticism and Benefits

Amid the voluminous criticism surrounding SOX, likely the loudest dissent has been voiced over the cost of compliance with Section 404's required certification of internal controls. Moreover, "seventy-two percent regarding material information" now result in maximum imprisonment of ten years (formerly five years), fines against individuals of JPY 10 million (formerly JPY 5 million), and fines against corporations of JPY 700 million (formerly JPY 500 million). Id. Penalties against insider trading and non-submission of a registration statement now result in maximum imprisonment of five years (formerly three years), fines against individuals of JPY 5 million (formerly JPY 3 million), and fines against corporations of JPY 500 million (formerly JPY 300 million). Id.; see FIEL Law No. 2 of 1948, arts. 197, 197-2 (amended 2006) (Japan). Somewhat similarly, Sarbanes-Oxley Section 306 prohibits the sort of insider trading carried out by Enron executives during the blackout period of employees' 401(k) plans and provides remedies to correct any such action. See Sarbanes-Oxley (SOX) Act of 2002, Pub. L. No. 107-204, § 306, 116 Stat. 745 (2002).

206 FSA DESCRIPTION, supra note 8, at 17.

207 Id. Formerly, the only penalties in force were criminal penalties against customers. Id.

208 Notably, beyond the specific criticisms of SOX, one commentator has expressed concern that "[t]he tone of that [critical] discourse may undermine one the Act's fundamental principles: ethical and diligent compliance." Cheryl L. Wade, Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine its Benefits?, 39 LOY. U. CHI. L.J. 595, 597 (2008).

209 With the average cost of Section 404 compliance for an average company in 2004 at $4.36 million, INTERIM REPORT, supra note 175, at 5, "ninety-four percent of executives from 217
of directors surveyed in the Americas said SOX made them too cautious, and consequently they are ‘not taking the necessary risks to drive growth.’”

Additionally, due to the enhanced risk of litigation liability associated with publicly traded companies, “the cost of D&O [Director & Officer] insurance has risen by 25% to 40% for companies with healthy balance sheets, and as much as 300% to 400% for companies with financial troubles.”

These effects can profoundly impact the very market that SOX was intended to strengthen, with specific data revealing such deleterious consequences. The enhanced risk of litigation liability stated above has been cited as a principal cause of the diminished competitiveness of U.S. capital markets. Furthermore, U.S. markets have seen a drop in initial public offerings (IPOs), particularly among foreign firms, which are focused more on other markets such as Shanghai. Given the high compliance costs associated with SOX, Section 404 has proved particularly burdensome on small companies, driving many out of primary U.S. markets and, instead, directing them to the Pink Sheets. Alternatively, some companies leave the public markets altogether and “go private.”

companies surveyed in 2005 felt that the cost of compliance outweighed the benefits of SOX.” Wade, supra note 208, at 595–96.

210 Id. at 596.


212 See INTERIM REPORT, supra note 175, at 5 (noting that “[c]lass action settlement costs have increased [in the U.S.], and [corporate] directors’ and officers’ insurance rates are six times higher in the United States than in Europe”).

213 Interview with Robert P. Bartlett III, Assistant Prof. of Law, Univ. of Ga. Sch. of Law, in Athens, Ga. (Sept. 25, 2008).

214 Id. The Pink Sheets is not a stock exchange. Id. To be quoted in the Pink Sheets, companies need not fulfill any requirements, such as filing financial statements with the SEC. Id. The companies quoted in the Pink Sheets tend to be closely held, extremely small, or thinly traded. Id. For more information on the Pink Sheets, see Pink Sheets, http://www.pinksheets.com (last visited Jan. 21, 2010).

215 Interview with Robert P. Bartlett III, supra note 213. While many scholars conclude that the rise in “going private” transactions since 2002 is a result of the costs of SOX compliance, such conclusions have been called into question. Compare Carney, supra note 211, at 142 (arguing that the rise of private transactions is attributable to SOX and, specifically, Section 404 as the “the principal factor in [publicly traded companies’] increased costs”), with Robert P. Bartlett III, Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms’ Going-Private Decisions, 76 U. CHI. L. REV. 7, 8 (2009) (arguing prior studies have assumed that the going-private firm has, by doing so, become “immune” from complying with SOX and thus was so motivated when, in actuality, many of the firms typically cited by such prior studies do not become immune from SOX, particularly Section 404).
Despite these critiques, SOX has provided a number of significant tangible benefits. First, it has improved documentation and standardized processes. Additionally, in improving upon the situation present in Enron and other similar cases, it also increased audit committee involvement. Finally, and among its greatest benefits, SOX strengthened the control environment. Indeed, "the number of companies that disclosed serious chinks in their internal accounting controls jumped to 586 in the first four months of 2005, compared with 313 for all of 2004." It is not surprising that, through the required certification of their companies' controls and reporting, "some chief executives acknowledge that . . . they discovered accounting inaccuracies, acquired a better understanding of how their companies operate, and were able to cut costs and be more productive in other aspects of their businesses." 

In light of such benefits, it has been concluded that "the policy behind Sarbanes-Oxley[, that of transparency,] is essential for the proper functioning of efficient capital markets." Thus, rather than the traditional mantra "business is good, government is bad," businesses, "instead of bemoaning the Sarbanes-Oxley legislation, should adopt a new mantra: 'Why Not Tell the Truth?' "

B. The FIEL: Post-Passage Developments as a Window to Its Future

A variety of developments since the enactment of the FIEL provide some insight into its future effectiveness. As an initial matter, it should come as no surprise, given the FIEL’s expansive reach, that the statute has been the subject of criticism. As one might expect, critical scrutiny originates primarily from those most subject to the law’s regulations. Major Japanese banks’ investment trust sales and other commission-based businesses saw significant declines in the fiscal year ending March 31, 2008.

217 Id. at 136.
218 Id. at 134.
220 Id. at 605–06.
221 Murdock, supra note 37, at 526.
222 Id. at 525.
223 Id. at 526.
224 See New Rules Turn into Head-on Winds for Major Banks’ Retail Businesses, NIKKEI WKLY. (Japan), June 2, 2008, available at 2008 WLNR 10404347 (noting that "[t]he implementation of
The effects of the U.S. subprime mortgage problem on the stock market were primarily to blame; however, in Japan, the FIEL’s requirement that sellers of such investment vehicles explain the accompanying risks more adequately also played a role. A director in charge of retail operations at a major bank commented, “Our sales staff have lost their nerve now that violating the law is a distinct possibility.”

The general timing of the FIEL—a law that, by design, increases restrictions on certain market actors, including banks—arrives at a time when a number of other factors are constricting Japanese markets. For example, the privatization of the Japanese postal system and its immense banking operation saw the entry of powerful competition into the banking sector. However, in response to concerns over constriction, many may point to the long-term consumer benefits flowing from greater market competition. A further set of factors includes the general global economic recession and increased fuel costs, which have caused a rise in the number of corporate failures, prompting “Japan’s six major banks [to] set aside a combined 380 billion yen ($3.68 billion) to write off bad loans . . ., [an increase of] 40% on the year.” But, as hindsight is 20/20, it would be inaccurate to level criticism against the chosen timing of the FIEL when the scale of the global economic slowdown was generally unanticipated.

A final criticism can be levied, as in the SOX context, against the costs of compliance with the FIEL. Though there is insufficient data to date, it is likely that the thousands of publicly listed companies subject to the FIEL have expended significant human and financial resources in preparation for implementing the FIEL’s new requirements. A case in point is the dramatic shortening of the deadline for institutional investors’ reporting.

As described in Part III above, rather than filing a report to the FSA once every three months, institutional investors must now file roughly every two weeks. From the institutional investors’ perspective, this is likely a significant and costly change. However, the FSA has established an electronic system known as Electronic Disclosure for Investors Network (EDINET) to facilitate three laws, including the [FIEL], hurt” these banks). These sales were down approximately 20%.  

---

225 Id.
226 Id.
227 Id.
228 Id.
229 Id.
230 See discussion supra Part III.
231 Fujitsu Completes Financial Services Agency’s New EDINET System; New System
the disclosure of information on publicly listed companies in accordance with the FIEL. To be sure, there are costs to a company associated with converting its current financial system to an EDINET-acceptable format. However, some portion of such costs is likely to be temporary, lasting only as long as it takes a company to make the transition. Other costs to maintain the new system, however, would likely need to be absorbed by the company or passed on in the aggregate to its customers.

In the face of the inevitable difficulties and costs of transitioning from the old regulations to the FIEL, one must look to the law's core purpose to determine whether such growing pains are justified. Indeed, the FIEL's stated objectives of strengthening Japan's securities market, investor confidence therein, and the related attractiveness of the market to FDI are by no means quickly and easily attainable. However, the objectives' complexity detracts neither from their importance nor from their justification as the basis for the law's requirements.

The breadth of the law's reforms is powerful evidence of the Diet's commitment to achieving the FIEL's objectives. However, the strongest evidence of a true commitment to the law's desired ends comes not only in the form of a steadfast dedication to the law as written but also through the fundamental principles that serve as the law's foundation.

The Japanese government initially displayed its commitment to the objectives of the FIEL by vigorously enforcing it, as evidenced by its response to a number of FIEL violations. For example, at least two instances have occurred involving firms who used "circular transactions" in order to...
"artificially boost sales and profit figures."

In one instance, the offending company inflated its reported sales figures by 45%. The second company, in addition to reporting inflated sales figures, also falsely reported net profits over a four-year period when it had actually suffered losses in each of those years. In response to these FIEL violations, the former company's top executives were arrested and the latter company was brought under investigation with the likelihood of FIEL-violation charges being brought.

Beyond enforcement, perhaps the most telling evidence of the government's dedication to maximizing the FIEL's effectiveness has been a responsiveness to market needs in revising the law to further align it with the FIEL's objectives. For example, Japan's Upper House passed a bill in June 2008 to revise the FIEL. The reforms included "establishing a market exclusively for professional traders, introducing new exchange-traded funds in commodity futures, and instituting harsher penalties for those who breach market regulations such as insider trading and false reporting." Such revisions were considered "necessary to raise the competitiveness of Japan's markets in a comprehensive manner."

Additional reforms currently under consideration also focus on expanding the attractiveness of Japan's markets both domestically and internationally. One such reform, which was to be submitted to the Diet in 2009, would "enable stock and commodity exchanges to combine their operations." This is of importance to the global competitiveness of Japan's markets, as neither Europe

---

235 Ex-IXI President, 4 Exes Held over Accounting Fraud, DAILY YOMIURI (Japan), May 30, 2008 [hereinafter Ex-IXI President], available at 2008 WLNR 10131848.
236 Id. IXI Co., an Osaka-based IT firm, reported sales of about 5.5 billion yen, a figure that was revealed to be padded by 1.7 billion yen. Id.
237 NIWS Sales Overstated, supra note 234. As a result of its false sales and profit reporting, NIWS Co. HQ Ltd. managed to collect thirteen billion yen through two public stock offerings. Id.
238 Ex-IXI President, supra note 235; NIWS Sales Overstated, supra note 234.
241 Id. (quoting Financial Services Minister Yoshimi Watanabe).
nor the United States “impose[ ] barriers between stock and commodity exchanges.”

An additional reform “exclud[es] a minor form of corporate action” from the FIEL’s ban on insider stock trading. In keeping with the government’s process of enacting the FIEL itself, this reform was to be open for public comment before it would be implemented. Moreover, given a growing global emphasis on addressing climate change, a further timely reform “enables bankers to directly trade in greenhouse gas emission credits—opening the door to the establishment of a carbon credit market in Japan.”

The Japanese government’s willingness to make necessary adjustments to its finely-wrought legislation demonstrates a degree of flexibility and a recognition of the reality of changing market needs. If taken to an extreme, such a policy of legislative revision could have the effect of watering down the law’s initial potency. However, reaching such an extreme is a highly unlikely proposition in the case of the FIEL, as it would run counter to the Japanese government’s demonstrated commitment to seeking a balance between market stimulation and investor protection.

In the end, successfully mitigating the possibility that the FIEL will be handicapped by any amendment will be based on whether the revision is well-considered within a broad, long-range view, balanced by giving priority to significant, shorter-term needs. Currently, Japan’s flexible approach provides a means by which the FIEL’s objectives may be attained.

V. CONCLUSION

It is impossible to imagine that a statute as comprehensive as the FIEL would not be met with some criticism. Thus, the effectiveness of such a statute should not be measured by its unanimous acceptance, but by whether, on the balance, it delivers the goals it sets out to achieve. The FIEL has in its sights the truly Herculean task of reestablishing the stability of and confidence in the country’s financial markets. Japan faced an undeniable need, both for a critical revision of outdated securities regulation and for a market encouraging of FDI. Moreover, to the credit of the Japanese government, the FIEL has been

244 Japan to Narrow Scope of Insider Trading Ban, JIJI PRESS ENG. NEWS SERV., Oct. 1, 2008, available at 2008 WLNR 18676056. The FSA “plans to remove liquidations of minor subsidiaries from the list of important corporate steps subject to insider trading regulations.” Id.
245 Id.
246 Stuber et al., supra note 242, at 620–21.
adjusted to accommodate valuable market needs as they come to light. Thus, the past and present of the FIEL are promising signs that it will deliver the desired long-term objectives of its drafters.