

Financial Gatekeepers in Japan

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Background

- Influence of U.S. reforms after Enron.
- In the post-bubble period, accountants, rating agencies, and analysts in Japan often failed to warn investors of problems well before corporations collapsed.
- False disclosures by major corporations has recently been revealed (Seibu, Kanebo).

Problems with accountants

- Failure to detect problems of Yamaichi Securities, Ashikaga Bank, etc.
- MOF and politicians used to focus on the “order” of the financial system instead of true disclosure of bad assets problems.
- Supervision of accountants and accounting firms was mostly left to JICPA, the SRO.
- International accounting firms affiliated with Japanese accounting firms are criticized at home.

Moves for reform

- Amendments of Accountant Law (2003)
 - prohibition against providing any non-audit services to an issuer contemporaneously with an audit
 - audit partner rotation (7 years)
 - enhanced supervision = CPAAOB
- Introduction of SOX 404-type rule for internal controls is being discussed.
- Further reforms will come
 - 4 accountants are arrested on September 13, 2005 for assisting with false disclosures by Kanebo. Chuo-Aoyama, one of the Big 4 and associated with PwC, is being investigated.

CPAAOB vs. PCAOB

- Certified Public Accountants and Auditing Oversight Board (est. April 2004)
- Administrative agency established in FSA (i.e., financed by taxes)
 - FSA's direct supervision, establishment of Japanese SEC, or establishment of a private independent body were discussed as alternative approaches.
 - Functions of the Certified Public Accountant Examination and Investigation Board (CPAEIB) were expanded.
- It oversees JICPA's quality-control reviews of accounting firms
- It recommends the Commissioner of FSA to take action

Other problems with Japanese accountants (1)

Number of accountants and listing firms in major countries

	Number of CPAs	Number of listed domestic firms	Number of CPAs per listed domestic firm
	(A)	(B)	(A) / (B)
Japan	15,469	4,245	3.64
U.S.	335,111	5,295	63.29
U.K.	140,808	2,311	60.92
Germany	19,000	660	28.78
France	16,158	1,046	15.44
EU	500,000	7,000	71.42
China	135,652	1,285	105.56

Other problems with Japanese accountants (2)

- Times spent for audit is much shorter than other countries' cases.
 - The amount of time spent on auditing companies of similar sizes in similar sectors in the United States, the United Kingdom, Germany, France and Canada ranged from 20% to 180% more than in Japan.
- Low audit fees in Japan

Problems with Rating Agencies in Japan

- Designated Rating Agency (DRA)
 - Used in various regulations such as the capital adequacy requirements for securities companies; the eligibility criteria for shelf registration; ...
 - Securities registration statements and prospectuses have a column for DRA-rating .
 - In order to be designated, a credit-rating agency must satisfy the Commissioner of the FSA that it has the necessary experience, staff, structure, expertise, and independence (e.g., in terms of capital structure).
 - DRA is given for a specific period (2 years in recent cases).

DRAs and Non-DRAs

- R&I, JCR, Moody's, Standard & Poor's, Fitch
- R&I was formed from the merger of JBRI and NIS in 1998.
- Mikuni & Co.
 - Does not apply to become a DRA in order to keep the status of its ratings as “opinions”
 - Uses public information only
 - Runs by subscription fees only

The problem of rating lag

- Japan's fourth-largest supermarket, Mycal, filed for bankruptcy protection on September 14, 2001. The company defaulted on ¥350 billion of corporate bonds. ¥90 billion of the bonds had a face value of ¥1 million and were targeted at retail investors, 38,000 of whom lost money.
 - January 28, 2000: Mycal issued ¥40 billion of bonds for retail investors, A- rating from JCR
 - September 6, 2000: JCR lowered its rating to BBB
 - December 12, 2000: Mycal issued ¥50 billion of bonds for retail investors, BBB rating from JCR
 - August 17, 2001: JCR lowered the ratings on both to BB
 - September 14, 2001: Mycal defaulted on both bonds

Rush in upgrading by foreign rating agencies since 2004

- Unusually large number of Japanese firms have been upgraded since 2004 by Moody's & S&P
 - Moody's raised its ratings on 115 companies (roughly 40% of the Japanese companies it covers), S&P raised its ratings on 64 companies (roughly three times as many as in 2003).
 - The rating gap between the Japanese and the non-Japanese agencies (traditionally regarded as less generous by two or three notch) narrowed considerably.
- Background
 - Economic recovery
 - Revision of traditional bias by foreign agencies
 - Basel II ?

Analysts in Japan

- Rules (Resolutions by JASDA) are being tightened
 - internal control for analysts' independence and uses of information (January 2002)
 - restriction on securities transactions by analysts (January 2002)
 - disclosure of conflict of interest (January 2003)
 - rules for use of third-party research (March 2004)
 - Prohibition against involvement in investment banking business (March 2004)

Backgrounds

- Reforms in the U.S.
- Specific issues in Japan
 - Errors in ING's research report on Daiwa bank caused bank's share price to plummet in 2001.
 - Posting of third-party reports on a brokerage firm's web site as if they are independent research. The reality was that the brokerage firm selected which companies should be posted and paid for the report.
 - A provider of third-party report was buying the recommended shares by himself beforehand.

Additional discussion

- Should we regulate FGs ?
- How should FGs be regulated ?
- Who should regulate FGs ?

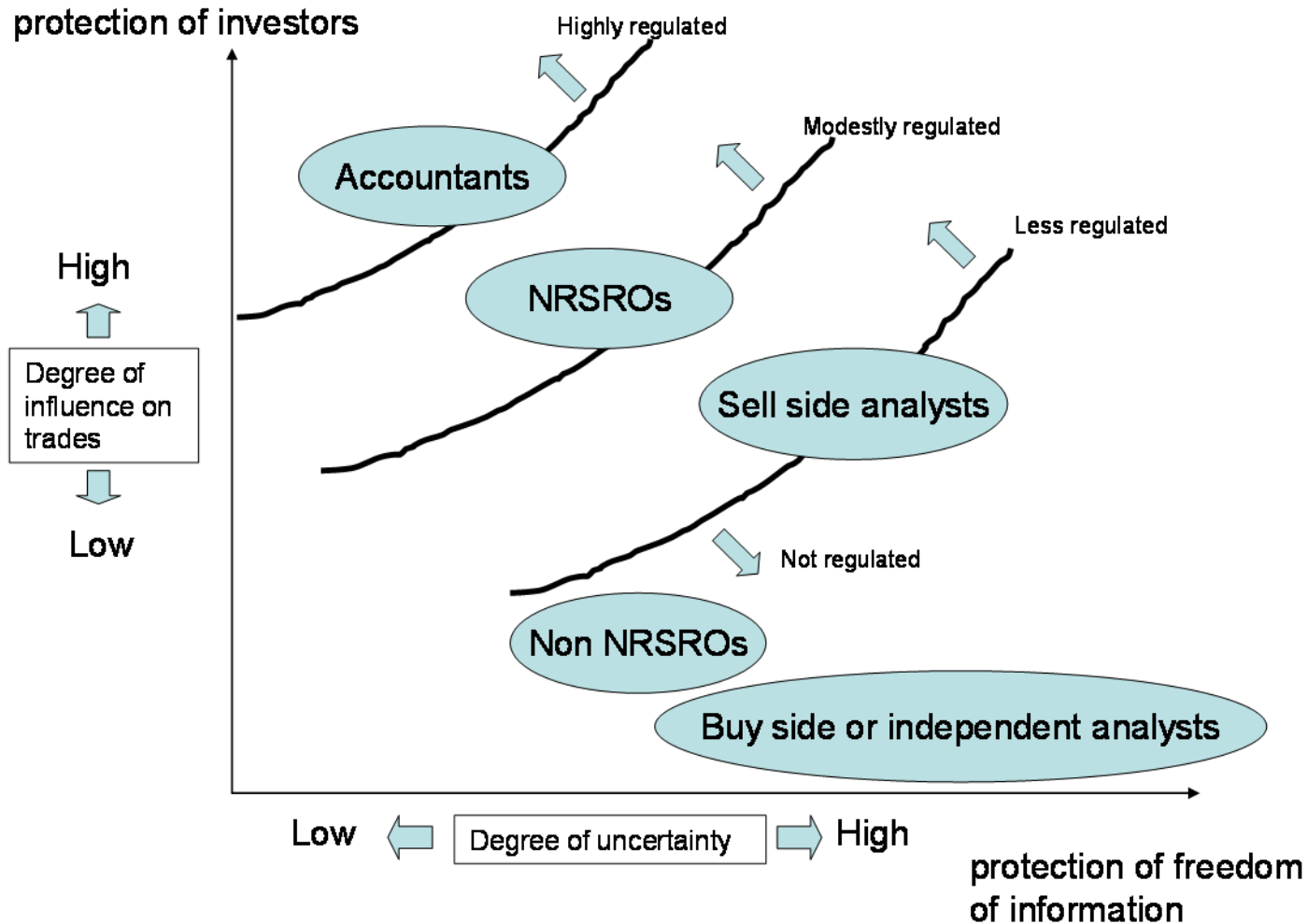
Should we regulate FGs?

- Two variables
 - Influence on securities trading
 - More influence \Rightarrow more regulation
 - Reason = protection of investors
 - Uncertainty or subjectivity of the information
 - More uncertainty or subjectivity \Rightarrow less regulation
 - Reason = protection of freedom of providing (receiving) information

Comparison between accountants and sell-side analysts

- Influence on trade: accountants $>$ analysts
 - information by accountants is fundamental in securities trading
 - there are many sell-side analysts and other sources of information
- Uncertainty and subjectivity: accountants $<$ analysts
 - accountants' information is supposed to be certain and objective
 - analysts' information is uncertain and subjective

Need for regulating FGs



Are the following situations justifiable?

- NRSROs are not really regulated now
- Financial planners might be classified as FG but some are not registered as investment advisers
- Regulatory environment for sell-side analysts not as strict in Japan as in the U.S.
- Regulatory environment for accountants in Japan is not as strict as in the U.S.

How should FGs be regulated ? (1)

- Two area of consideration
 - availability and competition
 - conflict of interest
- Availability and competition
 - If players are few, the influence of one player will be large. Should we regulate more?
 - Bad regulation would further reduce the number of players and make things worse
 - Competition would solve potential problems to some extent through market discipline
 - Competition policy should be important
 - Should Japan introduce public policy to increase the number of accountants and subsidize independent analysts ?

How should FGs be regulated ? (2)

- Conflict of interest
 - It is not easy for FGs to collect fees from users of their information. So conflict of interest is inherent in FGs
 - What is important is to control the damage; it is not necessary to limit the freedom of business models etc.
 - Restrictions of business models could reduce availability and competition of FGs.
 - Two trends in financial regulation
 - Banks' securities business – Less strict rules to avoid conflicts
 - Financial gatekeepers, board of directors - Stricter rules to avoid conflicts
 - Shouldn't accountants provide non-audit service ?
 - Shouldn't sell-side analysts be involved in investment banking business ?

Who should regulate FGs ?

- Protection of investors may not be the first priority for a government.
 - In Japan, the FSA used to prioritize the “order” of the financial system rather than timely disclosure of bad asset problems
 - Should CPAAOB in Japan be separated from FSA?
 - Should Japan establish U.S.-type SEC separated from banking and insurance supervisors?
 - Should a country have new and independent organization solely devoted to investor-protection with enough professional staff and independent financial resources, similar to the central bank for the independent monetary policy ?