Financial Gatekeepers in Japan

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1. Introduction

1) Why the role of financial gatekeepers has become an issue

Accountants, analysts and credit-rating agencies occupy a middle position between investors and investment products and they function as gatekeepers to financial markets by providing information to investors. When these financial gatekeepers face conflicts of interest or engage in inappropriate behavior, investors' decision-making process is distorted and their interests are put in jeopardy.

Despite a mandate to protect investors, securities regulators have not clearly defined the role of financial gatekeepers and they rarely impose direct controls over their activities in the same way that they regulate corporate disclosure, broker-dealers, investment advisors, and securities fraud. The collapse of Enron and a series of corporate scandals have called into question this relatively lenient treatment of financial gatekeepers.

Accountants have been accused not simply of being aware of accounting irregularities but even of aiding and abetting the perpetrators. Arthur Andersen, Enron's auditor, is suspected of putting higher priority on carrying out more lucrative consultancy work for the company than on ensuring that its accounts were in order.

Similarly, some securities analysts are suspected of succumbing to explicit or implicit pressure to write rosy reports for (potential) corporate clients in order to win investment banking business. The temptation for such bias is exacerbated by the fact that often analysts' compensation depends on the performance of their firm's investment banking department. Investors who trust the objectivity of analysts' reports suffered big losses when reality of the client's situation is exposed in the market.

Credit-rating agencies also came in for considerable criticism for maintaining investment grade ratings on Enron until just before the company collapsed. It has been suggested that ratings agencies' dependence on fees for rating corporate debt issues conflicts with their obligation to provide investors with timely and accurate information on a company's status.

2) Background on the role of financial gatekeepers in the United States

Although the collapse of Enron in 2001 and the ensuing corporate scandals highlighted the problems with financial gatekeepers and led to specific reforms, all of these problems had been identified previously. In particular, the issue of biased reporting by equity analysts working for investment banks had been discussed frequently since 2000 and the bursting of the dotcom bubble. Similarly, the Securities and Exchange Commission (SEC) raised the question of how best to regulate credit-rating agencies on several occasions since 1992, issuing a concept release in 1994 and a rule proposal in 1997. And as early as June 2000 the SEC proposed a rule prohibiting accounting firms from soliciting consultancy work from their audit clients, reflecting the regulator's concern that accounting firms' efforts to diversify operations by expanding their consulting services might affect the independence and objectivity of their audits.

Two factors intensified concerns about financial gatekeepers in the late 1990s. First, the number of private households investing in mutual funds and shares increased during the previous 10 years. This meant that more market participants depended on information provided by financial gatekeepers to value securities and misjudgments by financial gatekeepers affected a growing number of investors.

Second, the potential for conflicts of interest among gatekeepers also increased. Both companies and investment banks cherished increasing hopes that the growth in the number of retail investors would increase the short-term impact of analysts' reports on share prices. Similarly, securities companies saw their revenues from investment banking grow faster than their revenues from brokerage.

At the same time, credit-rating agencies kept replacing revenues from subscriptions to their data services by a business model that relied on fees from corporate clients. Similarly, income from consultancy work has come be the major source of income at many accounting firms—not just at Arthur Andersen.

The general reason for these increasing conflicts of interest is that, as financial gatekeepers have found it increasingly difficult to persuade customers to pay for information services, they have come to rely more on fees from issuers.

3) Background to the problem of financial gatekeepers in Japan

In recent years Japan has also seen growing interest in the role of accountants, credit-rating agencies, and analysts, as well as some regulatory reforms. Three factors spurred these changes. First, the bad debt problem and stock market slump of the past 15 years led to calls for reform of the country's debt and equity markets overall. In this reform, financial gatekeepers emerged as a focus of reform because they failed to warning investors about companies that collapsed during the burst of Japan’s asset bubble. Second, the controversy that followed the collapse of Enron in the United States has spread to Japan; and, third, Japan has also had its fair share of accounting scandals in recent years.

Thus, the gradual adoption by Japan of reforms similar to the ones the U.S adopted after Enron is not simply a reaction to problems that arose in the United States. Japan also had indigenous reasons to reform the regulation of its financial gatekeepers.

Let us first take a brief look at Japan's bad debt problem and stock market slump. When a number of companies (including some major ones) collapsed as the asset boom of the late 1980s turned to bust in the 1990s, the main issues were (1) whether the risks to these companies had been identified by external auditors and properly reflected in advance in financial statements, and (2) whether analysts and credit-rating agencies had given investors sufficient warning. Rating agencies and analysts were even criticized for depressing the share prices of some companies and driving them to the wall because of biased reports or, in the case of external auditors, excessively strict opinions.

Banks were accused of either underestimating their bad debts or misrepresenting their capital adequacy ratios and the stringency of external auditors was called into question. The Financial Services Agency (FSA), the regulator responsible for banks and their auditors, was also criticized for implicitly admitting better looking disclosure prepared by the banks and audited by the accountant.

While issues about financial gatekeepers in Japan came to light in the course of dealing with the country's bad debt problem, ensuring proper behavior on the part of financial gatekeepers is essential to avoiding a recurrence of the NPL situation. Because the scale and duration of the bad loan problem are seen as a consequence of Japan's over-reliance on banks, it is necessary to increase the role of securities markets in the economic system. In an economy that relies excessively on the banking system, economic changes will have an exaggerated effect on banks' balance sheets and lead to bad debt problems. In June 2001, soon after it came to power, the Koizumi government made assigning securities markets a more important role one pillar of its economic reform program. Improving investor protection is one objective of this program, and reforming the rules governing gatekeepers is one of its most important elements.

In the United States, securities markets have traditionally played a major role and the recent increase in retail investor participation in securities markets fueled the debate about the role of financial gatekeepers. In Japan, on the other hand, reform of the rules governing the role of financial gatekeepers, which has been relatively minor in the bank-dominated financial system, is one means the government is using to revitalize securities markets. The fact that Japan's financial system has been dominated by the banks may have been one reason why it took so long to recognize the importance of financial gatekeepers.

Although the debate about reforming financial gatekeepers in Japan has been influenced by the particular situation in Japan, this in itself was not enough to lead to calls for specific measures straight away. What changed was the debate in the United States that followed the collapse of Enron. Even though Japan had experienced similar incidents involving financial gatekeepers, albeit with some differences of degree and nature, the need to reform the rules governing their role was not seen as a priority. But the measures adopted in the United States in response to Enron had a big impact on Japan and helped to speed up the reforms already under way there.

In addition, the discovery in October 2004 that Seibu Railway, a leading company listed on the First Section of the Tokyo Stock Exchange, had falsified its securities filing and that the former management of Kanebo, another well known company on the First Section of the Tokyo Exchange, had perpetrated a major reporting fraud helped to accelerate improvements in internal controls, corporate governance, and auditing procedures, thereby bringing Japan's reforms more into line with the recently adopted reforms in the United States.

As we have seen, the debate about reforming the role of financial gatekeepers in Japan was driven by three factors: existing efforts to solve problems in debt and equity markets; U.S. capital market reforms following the collapse of Enron; and a series of major accounting scandals in Japan. The rest of this report examines the arguments in the debate on the role of financial gatekeepers in Japan and compares them with the reforms adopted in the United States.

2. Accountants in Japan

1) The end of the asset boom of the late 1980s and the reliability of financial statements

With the end of Japan's asset boom of the late 1980s, Japanese companies were confronted with over-employment, over-investment and excessive debt and Japanese banks were confronted with nonperforming loans ("bad debts") and depreciating equity portfolios. In this situation, many banks and companies are known to have cooked their books—or are suspected of doing so—out of concern that accurate reporting of declining asset values would undermine their share prices or threaten their existence.

Although the initial cover up was carried out in the belief that the decline in asset values would be temporary, unrealized losses mounted as asset values continued to decline, and from 1996 onwards a series of major bankruptcies occurred as companies found themselves no longer able to disguise the facts. In almost none of these cases did auditors give investors any warning in their audit reports. Besides, it was later revealed, some accountants did not take action when they noticed manipulated financial statements and, in some case they even assisted with manipulations to satisfy corporate clients. In other words, they did their business for corporate clients not for investors.

On 22 November 1997, Yamaichi Securities, one of Japan's "Big Four" securities companies, was discovered to have ¥260 billion of off-balance sheet debt and announced that it was ceasing operations. Four days later, the *Financial Times* published an editorial criticizing the state of accounting and auditing in Japan.[1]. The criticism was directed largely at the big international accounting firms that had accepted thee misleading opinions of the Japanese accounting and auditing firms with which they were affiliated.

Initially, Japan's financial regulators responded, it is probably fair to say, by trying to make financial statements not more, but less, transparent, in order to reduce the threat to the financial system.

First, on 24 December 1997, as part of a package of emergency measures, the Ministry of Finance's (MOF) Banking Bureau announced that banks could opt to value their equity portfolios at cost, rather than at the lower of cost or market. MOF was concerned that banks' capital adequacy ratios would be significantly reduced if they reported the extent of unrealized losses on their cross-shareholdings (the shares they held in corporate clients in order to cement business ties and prevent hostile takeover bids). By arbitrarily changing the valuation method, the Ministry hoped to avoid the consequences if banks' capital adequacy ratios fell below the international requirement. If this happened, MOF would have been forced to take prompt corrective action, which would have revealed the extent of the problem facing Japan's major banks and exacerbated the threat to the financial system or the banks would

[1] "Wonderland accounting," *Financial Times*, 26 November 1997. The description in this section of accounting reforms in Japan relies heavily on Isoyama (2002).

have been forced to call in loans to bolster their capital, which would have triggered a series of corporate bankruptcies.

Next, in March 1998, the government passed the Land Revaluation Law which allowed companies and financial institutions to value business assets, such as head and branch offices and factories, at market. The sharp drop in prices was putting severe pressure on profits of banks and financial institutions that had purchased property for speculative purposes during the asset boom of the late 1980s. By allowing companies and financial institutions to revalue business assets, most of which they had acquired before the bubble at low cost, the authorities hoped to give profits a boost that would help offset the stock market decline.

The unmistakable impression from these official responses is that in Japan the problem was not confined to auditing firms but extended to intervention by the government and regulators to change accounting standards in an effort to disguise the facts.

2) Initial efforts to reform the accounting system

At the end of 1998, the Big Five international accounting firms responded to the situation by demanding that the major Japanese accounting firms with which they had cooperation agreements include a warning in the auditor's statement accompanying the English-language version of the financial statements of their Japanese clients. The warning, which was to appear with annual reports starting with fiscal year ending March 1999, would say that the financial statements were intended for users familiar with Japanese accounting principles and auditing standards.

While the Japanese companies and auditing firms had no alternative but to agree they were shocked receive the same treatment as their counterparts in countries such as South Korea and Indonesia that had been under International Monetary Fund (IMF) administration following the Asian currency crisis.

In April 1999, the Certified Public Accountant Examination and Investigation Board (CPAEIB), an administrative agency under MOF, set up a working group to consider ways of making external auditors more independent and the system of supervising them more effective. The group published its findings in June 2000. Its main proposals were:

- Further consideration was needed of ways of making external auditors more independent. The Japanese Institute of Certified Public Accountants (JICPA) should be responsible for supervising the independence of external auditors.
- JICPA should establish self-regulating rotation rules governing the staff of auditing firms involved in audits
- Audits of companies above a certain size should be carried out jointly or by a team of auditors of a suitable size from an auditing firm rather than by individual accountants.

- JICPA should improve its quality-control reviews of auditing firms' internal controls and inspection systems.[2] Consideration should be given to a peer review system.
- The Ministry of Finance should remain responsible for the Certified Public Accountants Law, which regulates accountants and auditing firms, but it should assign more staff to the department concerned.
- The Provisions of Standard Remuneration for External Audits should be reviewed. Consideration should be given to requiring companies to disclose the number of days it takes for an audit and the fee charged.
- JICPA's powers as a self-regulating organization should be increased.
- Consideration should be given to adopting a system of limited liability for auditing firms.
- A study should be done of the consultancy work carried out by auditing firms. Firewalls need to be erected between the auditing and non-auditing departments.

Of these proposals, JICPA has adopted as a self-regulating rule the one calling for a rotation system for staff involved in audits. As we shall see, however, radical reform in Japan had to await the collapse of Enron.

3) More serious efforts to reform the system of certified public accountants following the collapse of Enron

As mentioned, the Koizumi administration first proposed policies to encourage greater use of the securities markets as an alternative to the banking system in June 2001. In order to facilitate this change, the government announced programs for reforming the securities markets in August 2001 and August 2002. The second of these contained proposals for reforming the work of auditing firms.

Although Japan obviously needed such reforms in order to establish a securities market in which investors could trust, the timing of the reform proposals was influenced by the Enron scandal. The program announced in August 2002 states that one lesson for Japan from the U.S. scandal is the necessity to improve regulation of auditing firms, and it called for reviewing the system of certified public accountants in Japan with a view to overhauling it as soon as possible (e.g., by increasing the number and improving the quality of accountants in Japan).

In response to the problems that led to the collapse of Enron, the U.S. Congress incorporated in the Sarbanes-Oxley Act measures to give external auditors greater independence and improve public supervision and regulation of their activities. Besides the U.S. Congress, the International Organization of Securities Organizations (IOSCO) also examined the problem of accounting fraud. Two IOSCO reports—"Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence" and "Principles for Auditor Oversight"—published in October 2002 also fostered accounting reform in Japan.

[2] Quality control reviews are conducted by JICPA staff. If any problems arise, the auditing firm is instructed to put its house in order.

4) Amendments to the Certified Public Accountants Law in 2003

Japan's efforts to reform its system of external auditing were the combined result of (1) the drive to enhance the role of the country's securities markets, (2) the collapse of Enron, and (3) international calls (centered on IOSCO). On 17 December 2002, the Financial System Council's Subcommittee on the Certified Public Accountant System published a report on how to improve Japan's system of accounting and auditing entitled "Reinforcement of the System of Certified Public Accountant Audits". After studying this report, the Liberal Democratic Party drafted amendments to the Certified Public Accountants Law. These were passed on 30 May 2003.

The main effects of the amendments on the gatekeeper issue were:

- Self-regulating JICPA rules restricting the length of time the same staff of an audit firm could continue to audit a company's accounts were given legal force. Hitherto, this had been limited to seven years. The government also adopted an ordinance prohibiting auditing firms from resuming work for a corporate client for at least two years afterwards.
- Auditing firms were prohibited from soliciting non-auditing business (e.g., consultancy work) from their corporate clients so long as they continued to audit their accounts.
- A new body, the Certified Public Accountants and Auditing Oversight Board (CPAAOB), was set up to oversee JICPA's quality control reviews of the internal controls and inspection systems of auditing firms.

According to a *Nihon Keizai Shimbun* survey of 200 leading listed companies in the first six months of 2005, 70 had been using the same auditing staff continuously for at least 10 years,[3] and 14 for at least 20 years. The revised Law stipulated that the period prior to the amendment would not count in the 7-year limitation on an auditing firm’s term.

The CPAAOB was set up partly because the self-regulating status of the quality control reviews that JICPA began in 1999 limited their effectiveness and partly because there was felt to be a need for external monitoring on the lines of the recently established Public Company Accounting Oversight Board (PCAOB) in the United States.

There were a number of alternative proposals for the CPAAOB. One was that the Financial Services Agency (FSA) should do the job itself; another was that a Japanese equivalent of the U.S. Securities and Exchange Commission (SEC) should be established to do the job; while yet another was that an independent private-sector body should be established. In the end, it was decided to reform the CPAEIB which was a deliberative administrative body of independent experts on accounting and auditing responsible for investigating suspected regulatory violations by certified public accountants and auditing firms as well as for conducting CPA examinations.

[3] *Nihon Keizai Shimbun*, 21 July 2005.

Accordingly, the CPAAOB was established in April 2004 as a revamped and enlarged CPAEIB with the following features:

- It would have its own, permanent secretariat.
- The chairperson and members would be appointed by the FSA, subject to the agreement of the Diet, and would perform their duties independently.
- In addition to assuming the CPAEIB's responsibilities for investigating suspected regulatory violations by certified public accountants and auditing firms as well as for conducting CPA examinations, it is responsible for monitoring JICPA's quality control reviews.
- In monitoring JICPA’s quality control reviews, in addition to checking on JICPA, it is responsible for checking the quality control policies and procedures, as well as the independence, of auditing firms together with the audit certification of companies that are audited. It also has the power to carry out onsite inspections, where necessary.
- If a CPAAOB investigation finds that an auditing firm has failed to comply with the law or with quality control standards, it will advise the Commissioner of the FSA to instruct the auditing firm to put its house in order or, if necessary, to impose a sanction. Also, if it finds that JICPA has not carried out its quality control reviews properly, it will issue recommendations to the Commissioner of the FSA to require JICPA to put its house in order.

5) Recent accounting problems and further reforms

The amendments to the Certified Public Accountants Law and the establishment of the CPAAOB greatly improved Japan's system of certified public accountants in recent years. In spite of that, however, the number of cases of accounting problems has increased. This is probably partly because by forcing auditing firms to put their houses in order they have made it more likely that problems will come to light. But the increase in the number of cases brought home the point that of the changed did not solve all of Japan's accounting problems and forced the authorities to consider further measures.

In October 2004, Seibu Railway was found to have falsified its financial statements for many years, and several other companies have since been discovered to have committed similar offences. In response, on 16 November 2004, the FSA published a policy document entitled "Measures for Ensuring Confidence in the Disclosure System," in which it indicated that the FSA would (1) review the system for checking companies' annual securities filings and (2) consider requiring firms to disclose their internal audit system and the number of years for which they have acted as auditors for a company, while the CPAAOB would (3) monitor the quality of audits by individual accountants as well as the independence and quality of auditing firms that have audited the accounts of a company continuously for many years, (4) review management assessments of the effectiveness of internal controls for financial reporting and their auditing by certified public accountants, and (5) consider ways of improving disclosure of corporate governance.

Furthermore, in "Further Measures for Ensuring Confidence in the Disclosure System” published on 24 December 2004, the FSA indicated, among other things, that

(1) a unit would be established either within the FSA itself or in the Securities and Exchange Surveillance Commission (SESC) to improve the system for checking companies' annual securities filings, (2) companies would be required to improve their corporate governance disclosure from the year ending March 2005, (3) the Business Accounting Council and JICPA would consider how auditing firms could tighten internal controls (e.g., for inspections and operations) and improve quality control, and (4) the CPAAOB would monitor auditing firms (especially their internal controls) and carry out onsite inspections.

In particular, in order to improve corporate governance disclosure, companies were required to disclose the following information from the year ending March 2005:

- the organization, staff and procedures for carrying out internal audits or audits by statutory auditors (audit committees) as well as the relationship between internal audits or audits by statutory auditors (audit committees) and external auditors
- any material interests (e.g., personal, financial, or business relationships) of independent directors or independent statutory auditors in a company.
- the names, positions, and number of years of continuous involvement of the certified public accountants involved in an audit; the composition of the rest of the audit team; and the arrangements for inspections when audits are certified by individual accountants.

The Business Accounting Council, an advisory panel to the FSA, conducted a review of how management assesses the effectiveness of a company's internal controls for financial reporting and of how certified public accountants carry out their audits and it issued a draft proposal with an invitation to comment on 13 July 2005. The draft proposal would require companies to produce an "internal control report" and accountants to produce an "internal control audit report." Once this document is amended based on the public comments, it is due to be incorporated in the 2006 amendments to the Securities and Exchange Law and to be obligatory for all listed companies with effect from the year ending March 2008.

Besides the 2004 case of Seibu Railway, another case—this time of window dressing—came to light in April 2005. Kanebo, which was under reconstruction with the support of the Industrial Revitalization Corporation following financial difficulties, was discovered to have inflated its results by more than ¥200 billion in the previous five years alone. The company lost its listing from TSE First section, and a former president and two senior managers were arrested by the Tokyo District Public Prosecutor's Office. Furthermore, the Public Prosecutor's Office and the SESC searched the premises of Kanebo's auditors, ChuoAoyama PricewaterhouseCoopers, and questioned the four accountants in charge of auditing the company. They were subsequently arrested on 13 September 2005. In addition, the audit firm is under investigation by the FSA.

In view of problems such as these, reform of Japan's system of certified public accountants is likely to continue. It has even been suggested that auditors should be required to report to the authorities anything suspicious they find when conducting an audit.

6) Comparison of reforms of the system of certified public accountants in the United States and Japan

As we have discussed, reform of Japan's system of certified public accountants has taken place as part of the government's effort to create a financial system that relies less on banking and more on the securities markets. The reform has also taken place at the same time as international efforts to boost confidence in international accounting following the collapse of Enron and as part of efforts in Japan itself to prevent a recurrence of accounting abuses. Let us compare the reforms in the two countries.

(1) Structure of the rules governing certified public accountants

Let us look at the framework within which the rules governing certified public accountants operate. In the United States, individual states award the qualification "certified public accountant" (or CPA) and they are directly responsible for supervising accountants' work. At the federal level, the SEC is empowered under the Securities Act of 1933 to regulate certified public accountants conducting audits of public companies subject to federal disclosure requirements. There have apparently not been many cases where the SEC has exercised this power, however. In September 1977, Congress considered the issue of how audits should be conducted, choosing self-regulation by the American Institute of Certified Public Accountants (AICPA) rather than regulation by the SEC. Only with the creation of the PCAOB following the collapse of Enron did the first real federal rules governing auditing come into existence.

In Japan, the Certified Public Accountants Law was passed in 1948. The qualification CPA is awarded by the State, which is also responsible for supervising the work of both individual accountants and auditing firms. JICPA was also established as a self-regulating organization under the Certified Public Accountants Law and is regulated by the State. Until the Financial Accounting Standards Foundation (FASF) and its standing committee, the Accounting Standards Board of Japan (ASBJ), were established in July 2001,[4] responsibility for setting accounting standards lay with the Business Accounting Council, an advisory panel to the Ministry of Finance. Given that regulation of CPAs was vested in the State in Japan and in individual states in the United States, it should have been easier for Japanese authorities than U.S. authorities to take direct action to deal with serious shortcomings in the way audits were conducted.

Even in Japan, however, the self-regulating organization was largely left to its own devices—partly because of the highly specialized nature of corporate accounting. Moreover, the State in Japan was perhaps not the ideal organization to monitor companies and gatekeepers, because, as we have seen, its behavior was motivated less by the desire to ensure the accuracy of the information companies disclosed to investors than by other considerations and cast doubt on the transparency of disclosure.

The recent accounting reforms are significant not only because they regulate how companies disclose information and how they are audited but also because they recognize the importance of transparency of disclosure and the role of the State in ensuring it.

[4] See the FASF's website.

Let us now look at some of the differences between the accounting reforms in the United States and Japan.

(2) Continuity of engagement

In the United States "continuity of engagement", the maximum period for which an auditor can continue to audit a company's accounts, is five years and auditors are banned from re-offering their services for five years. In Japan continuity of engagement is two years longer, and the subsequent ban on re-offering services is three years shorter. When these limits were debated in the Diet, the opposition called for adopting the same rules as in the United States, but the motion was defeated.

Faced with increased criticism after the case of Kanebo, on October 25, 2005, JICPA decided to shorten the allowable continuity of engagement to 5 years. But this decision is just a self-imposed regulation, not a law, and it applies only to the chief auditors of the Big 4 firms. .

(3) The PCAOB and the CPAAOB

The following are some of the major differences between the boards overseeing public accountants and accounting practices in the United States and Japan:

- The PCAOB is a non-profit organization regulated by the SEC whereas the CPAAOB is an arm of government, within the FSA.
- The PCAOB is funded from fees paid by members (auditing firms) and quasi-members (public companies). Some of these fees also go to fund the Financial Accounting Standards Board (FASB). The CPAAOB is funded by Japanese taxpayers, while the FASF, which is responsible for accounting standards in Japan, depends on publication revenue and membership fees. FASF faces financial difficulties as its membership has failed to increase and there have been calls to make compulsory. While 86% of companies listed on the Tokyo Stock Exchange were members of FASF as of the end of June 2005, a much lower proportion of companies listed on provincial stock exchanges belonged.[5]

Although the PCAOB cooperates with AICPA, its reviews cover individual auditing firms. The CPAAOB is responsible for monitoring quality control reviews by the JICPA and it only monitors individual auditing firms if inspections suggest that this is necessary.

(4) Liability

Discussion about fiancial gatekeepers in the United States often focuses on the role of liability, sometimes as a deterrent to their doing wrong and other times as a threat to their existence. The threat aspect applies to accountants since the greater number of legal suits and larger settlement amounts could jeopardize the sustainability of the Big-4 regime, as Professor Palmrose emphasized in this conference.

Law suits against gatekeepers are not as frequent in Japan as in the United States, even though Japan introduced reforms for gatekeepers similar to the U.S. ones, and

[5] *Nihon Keizai Shimbun,* 16 August 2005.

even though the number of suits rose as a result of more failures of major firms since mid 1990s. The relative rarity of lawsuits against accountants in Japan does not mean that Japanese audit firms are more managerially stable than American ones, because the existing Commercial Code in Japan already permitted administrative punishments to close down audit firms' business. Before amendment of the Certified Public Accountants law, the sanctions available to the FSA were, in order of severity, reprimand, suspension-of-business, and order-to-dissolve . According to the Commercial Code, if the FSA ordered an audit firm to suspend any part of its business or ordered any of the firm's auditors to suspend business, the whole firm would lose all clients. In 2002, Mizuho, a medium sized audit firm, was closed because of this treatment. The 2003 amendment of the Certified Public Accountants law added order-to-improve-business-conduct as a sanction that ranked below suspension-of-business in severity.

In April 2006, the Commercial Code will be changed to allow punishment of individual accountants involved in wrongdoing while not necessarily punishing the audit firm itself**.** Now the fate of ChuoAoyama is uncertain because the arrest of the large firm's accountants in connection with the Kanebo incident occurred before the revision of the Certified Public Accountants law and the Commercial Code.

Even though these legal changes would reduce the threat to audit firms, there is a growing understanding in Japan that the law suits are effective in detering fraud and in compensating civil losses. As a result, it is highly likely that audit firms in Japan will face more legal liability in the future.

7) Remaining issues

As we have seen, the 2003 amendment of Japan's Public Certified Accountants Law increased the independence of accountants but subjected them to stricter inspections. Since then, and following a number of accounting scandals, accounting reforms in Japan have followed a similar course to those adopted in the United States in the wake of the collapse of Enron (e.g., with calls for reports on internal controls). However, there are a number of fundamental problems that do not lend themselves to an easy solution.

(1) A shortage of accountants

A shortage of accountants in Japan means that it is difficult to be sure whether all public companies have been audited to the standard investors would like, even if accountants carry out their audits independently and to a high standard. At the of end of March 2005, Japan had only 15,000 certified public accountants compared to AICPA in the United States which had some 335,000 members in 2004. Moreover, AICPA membership is thought to represent only about 75% of the total number of accountants in the United States as many accountants belong only to state CPA associations. The small number of CPAs in Japan is clearly insufficient given that Japan 80% as many listed firms as the United States. The number of CPAs per listed firm in Japan is a small fraction of that in other countries (Table 1).

Moreover, CPAs are needed not only as external auditors but also as staff employed to prepare companies' financial statements. Since these activities are essential to proper disclosure, the dearth of CPAs means that the basic infrastructure of Japan's accounting market is woefully inadequate.

Table 1: Number of accountants and listed firms in major countries

	Number of accountants	Number of listed domestic frims	Number of accountants per listed domestic firms
	(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	18,470	1.046	17.65
EU	500,000	7,000	71.42
China	135,652	1,285	105.56

Note: The number of accountants is the latest data available from ICPA of each country .
The number of firms is for 2003 and is taken from the World Federation of Exchanges.
The figure for France refers to Eurex-listed firms.
Source: http://www.hi-ho.ne.jp/yokoyama-a/internationalaccounting.htm

The FSA, which is ultimately responsible for organizing CPA examinations, is aware of the need to produce more accountants. The report by the Financial System Council's Subcommittee on the Certified Public Accountant System mentioned above ("Reinforcement of the System of Certified Public Accountant Audits") set a target of 50,000 certified public accountants in Japan by 2018. While this is a welcome goal, it can also be seen as an admission that the shortage of accountants is unlikely to be solved in the next 10 years.

(2) Insufficient time for audits

Another problem in Japan is that auditors are not given enough time to do their job properly. In October 2003, JICPA set up a project team to compare the time spent on audits in different countries. The results were published on 16 September 2004. The team found that auditors in the United States, the United Kingdom, Germany, France and Canada spent from 20% to 180% more time than auditors in Japan auditing companies of similar sizes in similar sectors.

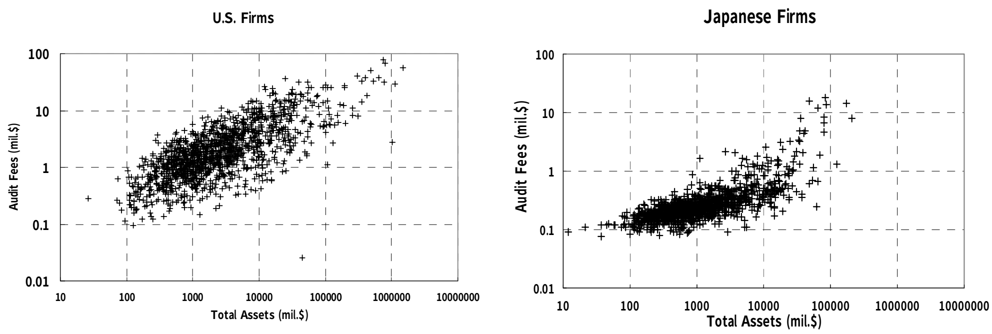
JICPA recognizes that auditors must be given more time to do their job if audits in Japan are to be more reliable. In an effort to achieve this, it has conducted a public relations campaign among both accountants and companies that use their services. In addition, it has included "sufficient time" among the criteria in its quality control reviews. At the same time, however, it faces calls from companies seeking to cut their costs by reducing the amount of time spent on audits.

(3) Low auditors' fees

As with the number of accountants, Japan does not stack up well against other countries in the level of auditing fees. For example, the range of auditors' fees in

Japan is much lower than in the United States. As shown in Figure 1, auding fees tend to increase with the asset size of the audited firm. According to Inoue (2006), both in the U.S. and Japan, asset size of the client is the single most important determinant of the auditor's fee.[6] Table 2 summarizes average auditng fees by asset size. As is appararent in this table, fees in Japan are extremely low compared with those in the U.S. Non-audit fees are also far lower in Japan than in the U.S.

Figure 1: Audit fees and asset size –US vs. Japan



Note: Japanese firms are those listed in the first section of Tokyo Stock Exchange and U.S. firms are those listed in the New York Stock Exchange. In both cases, the sample consists of those firms whose latest audit fee data were available as of August 2005. There are 1,344 Japanese firms and 1,327 U.S. firms.
Source: Inoue (2006).

Table 2: Audit fees and asset size –US vs. Japan

Asset size (US$billion)		Number of firms	Average asset (US$million)	Audit fees (US$million)	Other fees (US$million)
0.1～1	Japan	739	490.93	0.1995	0.0108
	U.S.	419	519.81	1.0568	0.3018
1～10	Japan	482	2873.47	0.3495	0.0408
	U.S.	640	3381.99	2.6250	0.8679
10～100	Japan	103	24971.65	1.7442	0.5706
	U.S.	224	27028.52	7.8038	2.7660

Note: See Figure 1. Seventeen Japanese firms and 6 U.S. firms are excluded because their assets are below US$ 0.1 billion. Similarly 3 Japanese firms and 38 U.S. firms are excluded because their assets are US$ 100 billion or greater.
Source: Inoue (2006)

Actually, JICPA used to determine the standard fee table for auditors in Japan, as mandated by the Certified Public Accountants Law. The table set out the minimum basic fee for each asset class. For examble, the minimum basic fee for auditing a firm with assets between 100 million and 300 million yen was set at 4.6 million yen per

[6] Other factors that have been confirmed as determinants of audit fees in both the United States and Japan are: complexity of the client, risk of the client, and Big-4 premium. A seasonal premium was confirmed in the U.S. but not in Japan. See Inoue (2006).

year, while the minimum for a firm with assets between 10 billion and 30 billion yen was set at 12.35 million yen. That is, fees for auditing a firm 100 times larger than another could be just 3 times more. The minimum basic fee for all firms with assets of 50 billion yen or more was set at 20.9 million yen. The extremely inelastic relationship that JICPA established between audit fees and firm size for small and middle-sized listed firms may explain why the plot for Japan differs from that for the U.S. in Figure 1. In addition to this basic fee, JICPA also set the minimum level of fees per day for each level of accountants involved in audit.

The justification for setting minimum standardized fees was to avoid excess competition among audit firms. In fact, competition among auditing firms has tended to depress fees since the amended Certified Public Accountants Law, which ended JICPS's role in determining fees, went into effect on 1 April 2004.

Of the 98 companies responding to a *Nihon Keizai Shimbun* survey of the companies constituting the Nikkei- 225 Index, 84% indicated that they objected to any increase in the fees paid to auditors. While 35% objected because they wanted to reduce costs from non-core activities, 46% objected because they did not expect the standard of the audits to improve. Only 3% of responding companies accepted the need to increase auditors' fees in order to improve the quality of the information provided.[7]

Reliable auditing is crucial to making Japan's financial system more market-oriented. Auditors have come under more careful monitoring and their work has been made more onerous as a result of scandals in the U.S. and Japan, but a shortage of certified public accountants, inadequate time spent on audits, and low auditors' fees are major constraints on achieving the goal of improving the quality of auditing in Japan. In the short term, it is difficult to increase the number of certified public accountants significantly without sacrificing standards, and the amount of time spent on an audit and auditing fees are basically determined by private parties and not subject to interference from the authorities. So, although the rules and regulations governing accountants in Japan are now similar to those in the United States, there are still big differences in how they are put into practice.

3. Credit-Rating Agencies in Japan

1) Development of credit-rating agencies in Japan

In the United States, the value of credit-rating infromation was highly claimed when there was a series of corporate bond defaults in the 1920s. A similar series of bond defaults in Japan at about the same time, rather than acting as a catalyst to the formation of credit-rating agencies, led to measures restrict corporate bond issuance in order to stabilize the financial system. To give companies access to long-term funds, the government allowed the long-term credit banks and other government-controlled financial institutions issue bank debentures.

This situation continued during the period of high economic growth from the 1950s to the 1970s, when only a handful of companies that met stringent standards were allowed to issue bonds. These companies were considered highly unlikely to default, but, when they occasionally did, the trustee bank usually bought the bonds back at

7 *Nihon Keizai Shimbun*, 21 April 2004.

face value to avert any losses to investors. This was clearly not an environment likely to foster the growth of credit-rating agencies.

The situation began to change in the 1980s—partly as a result of the growing popularity of convertible bonds. At the same time, Japanese companies began to issue more bonds overseas, while pressure on Japan from the United States to encourage wider international use of the yen and to open up the country's financial markets led to a debate on whether the country's corporate bond market should also be deregulated. This discussion, in turn, led to a serious debate about the need for credit-rating agencies.

In its May 1984 report, the Japan-US Yen-Dollar Committee recommended that Japan introduce a credit-rating system. According to the report, Japanese companies wanting to issue Euroyen bonds would find it difficult to persuade overseas investors to accept the Ministry of Finance's issue standards and would have no alternative but to obtain a credit rating in order to be able to issue free of this constraint. The report also expressed the views that Japanese companies would need to obtain credit ratings from more than one agency, that credit-rating agencies would need to maintain their independence, and that issuers should be prepared to bear the fees for obtaining credit ratings as investors were unlikely to be willing to pay them when the risk of default on corporate bonds, all of which at the time were secured, was low.

The Japan Bond Research Institute (JBRI) (now Rating and Investment Information, Inc., or R&I) began bond-rating activities in 1979 as an in-house unit of Nihon Keizai Shimbun, Inc. and was incorporated as a joint-stock company in 1985, one year after the Japan-US Yen-Dollar Committee published its report. In the same year, Japan Credit Rating Agency, Ltd. (JCR) and Nippon Investors Service, Inc. (NIS) were formed and Moody's Investors Service and Standard and Poor's opened offices in Tokyo.

The practice of credit rating in Japan grew not so much out of investor demand, but really out of the introduction of a new system of corporate finance. Japanese companies issuing bonds overseas (see above), stimulated debate about deregulating the domestic bond market and the Ministry of Finance gradually relaxed its issue standards. Deregulation took place one step at a time to avoid disrupting the market with issues by problem companies. One interim measure adopted in 1992 required companies intending to issue a bond to obtain a minimum credit rating (instead of meeting certain quantitative standards). At the same time, the authorities introduced a system of designated rating agencies and required companies wishing to issue a bond to use one of these designated agencies. Thus, credit ratings were introduced in Japan as a requirement for issuing corporate bonds, in contrast with the United States, where credit ratings began as a business.

2) Regulatory use of credit ratings

Although the Ministry of Finance's bond issue standards were abolished in 1996, credit ratings from designated rating agencies are still required by a wide range of rules. The most important are: the capital adequacy requirements for securities companies; the requirements for special-purpose companies issuing commercial paper; the eligibility criteria for shelf registration; the requirements for referenced disclosure where this is permitted; the eligibility criteria for securities held in a bond investment trust; the criteria for exemption for securities companies, their officers and staff from the prohibition on unfair trading practices; entries in securities registration statements and prospectuses; and the eligibility criteria for purchases by the Banks' Shareholdings Purchase Corporation.

Securities registration statements and prospectuses include a column for "credit ratings" in their sections for information on securities where issuers have to enter the ratings obtained from designated rating agencies. (If they have obtained ratings from more than one designated rating agency, they have to enter each rating.) If they have not obtained a rating, they have to indicate this on the form. This means that, to all intents and purposes, a company will be unable to issue bonds unless it has a rating from one of these agencies.

Thus, like the United States, Japan has a system for publicly approving credit-rating agencies, although the reasons for introducing it were different. Furthermore, as we shall see, Japan also has many of the same problems associated with credit-rating agencies in the United States.

3) Oligopolization

The first problem is the small number of designated rating agencies. Japan currently has five such agencies. Three, Moody's, S&P, Fitch, are non-Japanese and two, R&I and JCR, are Japanese firms. R&I was formed from the merger of JBRI and NIS in 1998. Japan has one more agency, Mikuni & Co., which is not a designated rating agency but which is fairly widely used. As in the United States, the number of agencies with public approval is small and dwindling. But competition is relatively strong in Japan compared to the duopoly situation in the United States. With these powerful players already in the market, no other firms appear to be trying to enter and apply to become a designated rating agency.

At the same time, we should emphasize that it is not as easy for a new firm to become a designated agency in Japan as is to become an NRSRO in the United States. In order to become a designated rating agency, a firm must satisfy the Commissioner of the FSA that it has the necessary experience, staff, structure, expertise, and independence (e.g., capital structure).[8] The most important of these criteria is apparently experience, or the extent to which the agency's ratings are actually used, which makes it difficult for new entrants to qualify for designation.

4) Rating lag

Two months before the collapse of Enron, a similar case involving discrepancy between a company's credit rating and reality occurred in Japan. Mycal, Japan's fourth-largest supermarket, filed for bankruptcy protection on 14 September 2001 and defaulted on ¥350 billion of corporate bonds. The case was of major public concern because ¥90 billion of these bonds, with a face value of ¥1 million, were targeted at retail investors, 38,000 of whom lost money.

Mycal had issued ¥40 billion of four-year bonds on 28 January 2000, with an "A-" rating from JCR. The company issued ¥50 billion more in four-year bonds on 12

[8] "Cabinet Order on Disclosure of Corporate Information," Article 1(13-2).

October the same year, even though JCR had lowered its rating to "BBB" on 6 September. JCR lowered its rating on both bonds to "speculative status." on 17 August 2001, a month before the default. Although JCR was the only rating agency from which Mycal had requested a rating, other agencies had published revised ratings on the company of their own accord. For example, R&I lowered its rating on the company from "BBB+" to "BBB-" on 30 August 2000 and to "B+" on 4 June 2001. Similarly, S&P lowered its rating on the company from "BB" to "B," on 1 March 2000, while Moody's lowered its rating from "Ba3" to "B" on 31 July 2001. Mycal's was the first default on a publicly offered bond in Japanese history, and there was considerable criticism of JCR for having maintained its "investment grade" rating until just a month before.

Even if JCR had lowered its rating on Mycal's debt sooner, however, this might not have been much help to the retail investors who bought the bonds because Japan had no proper secondary market in small-denomination bonds of this kind. Some investors were able to sell their bonds to securities companies at a discount that reflected the downgrade, but they had to accept a large discount in the absence of a proper secondary market. Many retail investors could not imagine that a Japanese company might default and therefore decided to hold the bonds until redemption rather than take a large loss straight away.

At the same time, some quarters blamed the non-Japanese firm, S&P, for setting in train the events that led to the default with its early 2001downgrade that coincided with a sharp decline in the price of the company's shares. This criticism is reminiscent of the criticism levied at non-Japanese rating agencies for precipitating the end of Yamaichi Securities by downgrading the company's debt.

5) Ratings bias

The case of Mycal also raised the question of agency bias toward issuers. The rating by the agency Mycal that chose as the designated rating agency was more generous than the ratings of other agencies. There is speculation that JCR had incentive to give a favorable rating in order to boost its fee income and that Mycal had incentive to choose an agency that might be inclined to be generous in its rating.

Japan's third major domestic credit-rating agency, besides R&I and JCR, is unique in this and other respects. Mikuni & Co., Ltd. receives no fee income from issuers and depends entirely on income from selling its reports. It has therefore never applied to become a designated rating agency. Mikuni began marketing its credit ratings to investors and credit controllers in 1983. At first, because Japanese investors saw little risk of a Japanese company defaulting on its bonds it had few Japanese clients and Mikuni published all its reports in English for the benefit of non-Japanese investors. In 1995, when Japanese companies were going out of business with more frequency, Mikuni began to publish information in Japanese. As the company strongly believes that credit ratings are simply an opinion, it bases its ratings entirely on publicly available information. Mikuni has a reputation for being even more critical than Moody's. For example, it lowered its rating on Mycal from "BB" to "B" as early as August 1999 and to "CCC" in February 2001.

6) Ratings gap and changes since 2004

The general view is that Japanese rating agencies are more generous than non-Japanese agencies, with ratings by non-Japanese agencies usually two or three ranks lower than those by Japanese firms. Certainly, Japanese issuers tend to choose Japanese rating agencies. The fact that both of Japan's designated rating agencies depend almost entirely on fees from issuers does not account for their perceived ratings generosity since the U.S. rating agencies also depend largely on fees from issuers. Changes in the rating gap since 2004, however, suggest that non-Japanese rating agencies had previously been somewhat ungenerous toward Japanese companies.

Moody's and S&P caused a stir by raising their ratings on a large number of Japanese companies in a short space of time in the second half of 2004, as is shown in Table 3. As both agencies issued more upgrades than their Japanese rivals, the rating gap between the two groups narrowed considerably. Japanese companies and investors criticized the rush by Moody's and S&P to raise their credit ratings on Japanese companies as "playing catch-up with reality."

Table 3: Changes in ratings of Japanese corporations and corporate bonds by 4 major rating firms

	Upgrades				Downgrades			
	JCR	R&I	S&P	Moody's	JCR	R&I	S&P	Moody's
2003 2nd half	16	5	28	12	13	20	7	5
2004 1st half	20	20	29	19	24	17	11	0
2004 2nd half	59	41	79	128	8	18	22	0
2005 1st half	49	78	131	60	22	8	7	1

Note: Upgrades and downgrades include changes in both corporate ratings and bond ratings. They do not count changes in outlook.
Source: NICMR

In part, the upgrades by non-Japanese rating agencies reflected improvements in the balance sheets and income statements of Japanese companies, but they may also reflect the agencies' belated recognition of the fact that very few Japanese companies ever actually default. S&P acknowledged that this was the basis for reviewing its ratings.

A completely different explanation for the upgrades by the two non-Japanese rating agencies is based on the prospect of Basel II. Under Basel II most Japanese financial institutions are expected to choose the standardized approach to deciding risk weights for loans, which involves using credit ratings and the FSA is expected to prohibit them from using unsolicited ratings for this purpose. According to this view, the non-Japanese rating agencies, concerned that they might lose out because they have tended

[10] Recommendations from the Forum Group to the European Commission services , "Financial Analysts: Best practices in an integrated European financial market", September 4, 2003

to issue unsolicited ratings, decided to raise their ratings across the board in the hope of appearing more acceptable to potential customers.

7) Regulation of credit-rating agencies

In April 2005, the U.S. SEC proposed a rule required an NRSRO to establish a system to stem conflict of interest as well as a procedure to prevent abuse of non-public information. Also, it introduced an effective period for the no-action letter of NRSRO, instituted periodic checks when rating agencies try to renew their NRSRO status.

The Credit Rating Agency Duopoly Relief Act of 2005 submitted to Congress in June. will change the definition NRSRO from 'Nationally Recognized Statistical Rating Organization' to 'Nationally Registered Statistical Rating Organization'. That is, rating agencies will be registered by and formally regulated by SEC.

Meanwhile, the SEC is working together with NRSROs to establish a framework to enhance supervision over NRSROs to the extent possible under current laws. In any event, the regulatory environment for NRSRO in the U.S. will be improved.

The IOSCO is also taking steps to improve regulation. Its "Principles Regarding the Activities of Credit Rating Agencies" issued in September 2003 and "Code of Conduct Fundamentals for Credit Rating Agencies" which appeared in December 2004 are not official regulations but they demand effort by rating agencies to maintain independence, avoid conflict of interest, and control non-public information, and the like.

The FSA in Japan has not yet issued concrete measures to reflect these developments in the U.S. and by the IOSCO. But since Japan has the same types of problems concerning rating agencies as the U.S. has, it is time for Japan to reconsider the current system of designated rating agencies.

4. Analysts in Japan

1) Differences between analysts in the United States and Japan

One major issue with analysts in the United States, especially after the dotcom bubble burst, was biased reporting that led to losses for many retail investors. Because analysts' remuneration had come to depend on the performance of their employers' investment banking business, there was a tendency for them to write reports that boosted that business.

A second issue is that close contact between analysts and the management of the companies they write about gives them access to information unavailable to ordinary investors as well as making them vulnerable to pressure from those companies. This stems from the traditional practice of investor relations officers and senior managers of U.S. companies to offer their comments on analysts' earnings forecasts and analyses before they are published.

A third problem acknowledged by many U.S. securities companies is that their analysts own shares in some of the companies they cover—a practice that could compromise the objectivity of their reports.

In response to these concerns, the New York Stock Exchange and the National Association of Securities Dealers adopted a series of rules designed to ensure the neutrality of analysts, while the SEC adopted Regulation AC (Analyst Certification). These measures helped to reduce the risk of analysts being involved in situations of conflict of interest. The so-called Global Settlement between U.S. regulators and the top 10 U.S. securities firms that was reached on 28 April 2003 had a much greater impact than these measures, however. Among other things, the settlement (1) obliged securities firms to provide investors with independent, third-party research, (2) prohibited analysts from taking part in the sales activities of their investment banking divisions or in issuers' roadshows, and (3) required securities firms to publish data on their analysts' performance.

The position of analysts in Japan is different from their counterparts in the United States, in at least five respects. First, if analysts in Japan were found to write misleading reports, it would not be likely to cause an outcry on the same scale as what occurred in the United States when many investors lost money because they believed the biased reports of analysts. This is because the number of retail equity investors in Japan is small. Individual Japanese have traditionally invested only a small proportion of their personal financial assets in equities and equity investment trusts. Moreover, although a growing number of people have taken to buying and selling equities as brokerage commissions decline and Internet access increases, many of them are day-traders, who tend not to be interested in fundamental research.

Second, analysts in Japan do not have the charisma or the popular influence that U.S. analysts wield. This is partly because of the small number of retail equity investors in Japan and the rise of day-trading. And without this kind of influence over retail investors, analysts in Japan do not contribute to winning investment banking business for their employers to the same extent as their counterparts in the United States.

Third, analysts in Japan do not get early word from companies about their earnings. Companies themselves release their own earnings forecasts regularly and are expected to revise them, if necessary. The practice of U.S. companies to give analysts hints about earnings is intended to avoid the confusion that might result if the market consensus was wide of the mark.

Fourth, securities companies in Japan normally have a long-standing rule forbidding or severely restricting their analysts from investing on their own account, unlike in the United States, where the practice is common.

Finally, analysts in Japan have not been as involved in investment banking as in the United States and their remuneration is not normally linked directly to the performance of the investment banking division of their firm.

Japan has also recently tightened rules on equities analysts, but Japanese securities companies have not been forced to accept the same degree of regulation as U.S.

securities houses under the Global Settlement. This seems to be justified in light of the different position of analysts in Japan that we have pointed out.

2) Rules governing analysts in Japan

(1) Impetus for rules change

Tighter regulation in the United States, discussions by the IOSCO, and various domestic problems led the Japan Securities Dealers Association (JSDA) to amend its "Resolution on the Handling of Research Reports" and had individual securities companies revising their internal rules.

The JSDA has dual roles as a self-regulating organization and as an industry association. Part of the impetus for the JSDA's revised resolution on research reports, which the board adopted in January 2002, came from events that transpired in the United States. First, the Securities Industry Association (SIA, an organization representing 600 U.S. securities dealers) issued "Best Practices for Research," in June 2001. This document recommended best organizational practices for securities firms and for analyst reports. In addition, the U.S. Congress began hearings on analyst conflicts of interest in June 2001. Finally, the collapse of Enron, which occurred while these hearings were taking place, focused attention on the issue.

The direct trigger for the JSDA's revised resolution, however, was an analyst's report published in Japan. ING Baring Securities Japan Ltd., Tokyo Branch (ING) published a report on Daiwa Bank on 25 May 2001. The report mistakenly gave Daiwa Bank's (Tier 1) capital adequacy ratio for the year ended March 2001 as 4.79% instead of 7.49% and claimed that the bank had suffered a sharp decline in deposits, that caused depositors to question its future, when, in fact, the bank's deposits had actually increased. In addition, the report gave ¥50 as the fair value for the bank's shares, which had been trading at over ¥150 before the report was published, and gave them a "sell" rating. As a result, Daiwa's share price dropped to just over ¥130, and those institutional investors that had shorted the bank's shares on the basis of the ING report made a profit. Moreover, before it was published the report's contents had been leaked to ING's proprietary trading desk, which also made a profit by shorting Daiwa Bank's shares, although the person responsible for the short sales was apparently unaware of the report's existence.

Daiwa Bank lodged a complaint against the analyst's view that the fair value of its shares was ¥50 on the grounds that the reasons given were unclear. In response, in June 2001, ING published amendments and an apology in the national press. The matter was also investigated by the FSA, which published its findings and issued a business improvement order on 20 August 2001. The FSA found that the ING report contained erroneous figures that could mislead investors in a number of important respects and that ING had solicited business on the basis of the report—conduct incompatible with Article 4(i) of the Cabinet Order on the Rules of Conduct for Securities Companies. This cabinet order details the activities from which securities companies, their officers and employees are prohibited from engaging in under Article 42 of the Securities and Exchange Law and prohibits securities companies from publishing erroneous and misleading information that could mislead investors in a number of important respects. The FSA found that ING had not employed anyone to check its analysts' reports. In addition, it found that the research section in which the analyst concerned worked was housed in the same department as the equity trading section and that there were no firewalls to prevent leaks between the two sections.

The FSA took the following actions against ING. First, it required ING to draw up and implement measures to prevent a recurrence by establishing: (1) rules and a system for checking analysts' reports objectively and thoroughly; (2) proper firewalls between equity research and trading/investment departments; and (3) specific procedures for informing proprietary trading departments of any changes in recommendations and coverage in order to prevent them from trading in the securities of a company before a report on that company is published. Second, the FSA required ING to clarify who was responsible for the problems.

The FSA also asked the JSDA to consider drawing up rules to ensure that its members established firewalls between its equity research and trading/investment departments and in order to prevent analysts from front running.

(2) Rules introduced in 2002

In response, in January 2002, the JSDA board adopted a resolution calling on members to:

- establish a system of internal supervision to ensure that reports are both appropriate and reasonable in content;
- ensure the security of material information when analysts are either working for other departments or passing on material information to other departments;
- ensure that analysts are free from interference or intervention by other departments when writing their reports and guarantee their independence of opinion by ensuring that directors of underwriting and investment banking departments do not make clients or prospective clients any promises about the contents of such reports;
- set up a committee to check and assess the content of analysts' reports and try to improve their quality; and
- forbid analysts from either dealing in or owning the securities of any of the companies they cover unless expressly permitted and ensure that executives and employees do not deal on their own account on the basis of any material information obtained as a result of an analyst's report or research.

In addition, the resolution required members to draw up written internal rules and procedures incorporating these requirements.

(3) Rules introduced in 2002

Shortly after JSDA’s rules changes, the U.S. Congress passed the Sarbanes-Oxley Act. The New York Stock Exchange and the National Association of Securities Dealers also adopted self-regulating rules governing analysts, and the SEC carried out further investigations of leading Wall Street firms. Meetings of the IOSCO also featured discussion of various issues involving analysts.

In view of these developments, the FSA decided to request the JSDA board to amend its resolution. In January 2003, the JSDA added to the resolution rules requiring disclosure of conflicts of interest, drawing up a proper analyst remuneration system, and forbidding securities firms from letting issuers review analysts' reports prior to distribution.

The new rules on disclosing conflicts of interest required members to disclose the following information in their analysts' reports:

- Disclose that a situation could arise between them or one of their analysts and a company that is the subject of an analyst's report that might compromise the analyst's independence when the likelihood of this occurring is high.
- Disclose that a company that is the subject of an analyst's report has been the lead manager of an initial or secondary offering of securities when not more than 12 months have passed since the day on which the registration statement of the offering was submitted.
- Refrain from publishing in an analyst's report any investment ratings or target prices for shares when the member has been the lead manager of an initial or secondary offering of shares as part of a listing on a stock exchange or registration with the Japan Securities Dealers Association until 10 business days have passed since the listing or registration ("quiet period").

3) Tighter regulation of analysts since 2003

Following the amendments to the JSDA resolution in 2002 and early 2003, further measures tightening the regulation of analysts were implemented. These were triggered by the U.S. developments as well as events in Japan.

In the United States, the Global Settlement was announced in April 2003 and Regulation AC (Analyst Certification) came into force around the same time.

In Japan, two events cast doubt on the arrangements made by securities companies for dealing with reports produced by outside analysts.

- A securities analyst who had signed an agreement to write reports for a securities firm repeatedly bought the shares of the companies he recommended in before the reports were published and sold them afterward when the price had risen. When the securities company asked the analyst to transfer his trading account to them, he refused. The firm simply included in its agreement with the analyst a clause referring to the need to comply with the law. It mention anywhere in the analyst's reports the fact that he had a position in the securities he was recommending.
- Another securities firm commissioned reports from an outside source which it made available to its clients free of charge on its website. The securities firm specified the companies covered in the reports and paid the outside source for its services in accordance with the agreement between them, but it did not disclose this information to its clients, who were given the impression that the authors of the reports had chosen the stocks themselves. The SESC ruled that this amounted to presenting information about an important matter in a way that was likely to mislead investors (Article 4(i) of the Cabinet Ordinance Governing the Activities of Securities Companies on the Basis of Article 42(1)(ix) of the Securities and Exchange Law).

Following these events, in December 2003, the SESC recommended to the FSA that securities companies that used reports by outside analysts to recommend securities to their clients needed to make proper arrangements for dealing with such reports and the analysts who had written them.

In response, on 17 March 2004, the JSDA board adopted a second set of amendments to its Resolution on the Handling of Research Reports. Like the measures that had been taken in the United States, these new amendments consisted of restrictions on the involvement of securities analysts in underwriting and investment banking activities. Specifically, the amendments forbade them from taking part in promotional activities (e.g., investor briefings) involving these two departments.

According to the amended resolution, "promotional activities" refers to any activities intended to win underwriting or investment banking deals or transactions. As examples it gives (1) the case where an analyst takes part in a meeting concerning his employer's underwriting or investment banking department attended by a member or a client of either of those departments, (2) the case where an analyst makes a recommendation to a company on behalf of his employer's underwriting or investment banking department, and (3) the case where an analyst produces written material to support the promotional activities of his employer's underwriting or investment banking department.

The amendments also include provisions for how securities firms should handle reports they commission from outside analysts. Securities firms are now required (1) to ensure that any material conflicts of interest between outside analysts and the companies that are the subject of their reports are disclosed in those reports and (2) to inform their clients if they have paid outside analysts for their reports or instructed them to write about particular companies.

4) Regulating analysts and the implications for their future

The rule that probably has the biggest impact on analysts working for securities firms in Japan is the one in the latest set of amendments to the JSDA resolution; it restricts analysts' involvement in investment banking activities.

Although in Japan the remuneration of analysts working for securities companies is rarely linked to specific investment banking deals, how securities firms can recoup the costs of their research departments is a key issue and relations between analysts and the investment banking activities of their employers cannot simply be ignored.

The European Commission's Forum Group on Financial Analysts proposed a different, more indirect, approach to the conflict-of-interest issue from that followed in the United States and Japan[10]. The group argued that there is no need to forbid securities analysts from taking part in activities that promote their investment banking departments. Financial institutions should simply ensure that none of their analysts made any investment recommendations while they were involved in investment banking activities. This reflects the understanding that analysts' reports and valuations are important in the price discovery of initial public offerings.

The rules in the United States and Japan, in contrast, take a more direct approach to eliminating the risk of an analyst's independence being compromised: by forbidding analysts from being involved in promotional activities, where they are most likely to be subject to pressure from their investment banking departments. Analysts' involvement in investment banking activities is restricted to screening potential clients and carrying out due diligence once a securities firm has been appointed as advisor or lead manager.

It has been argued that under these rules, sell-side analysts working for U.S. investment banks and Japanese securities companies face a big reduction in income (both direct and indirect) for the investment banking work they do and that both their remuneration and the number of companies they cover will be affected.

Rules are not the only factor that can influence the future of sell-side analysts, however. Other factors include the growing use of passive management, the increase in the number of speculators, soft-dollar rules, and Regulation FD. Although there have not been any moves to introduce soft-dollar rules in Japan, their introduction in the United States or the United Kingdom would lead to more intense discussion of their possible introduction in Japan.

As for Regulation FD, some view that it is not as important in Japan as in the United States, since analysts in Japan have never performed the peculiar role that U.S. analysts play in bridging the earnings forecast information gap between companies and the market. At any rate, in a report issued in July 2005, the Financial System Council's Working Group on Disclosure concluded that Regulation FD will require further consideration in light of the IOSCO discussions.

Such developments raise the specter of a decline in the supply of high-quality company research reports below the level that is socially desirable. However, it is also possible to take the view that the current state of affairs—where stock-picking equity analysts are traditionally paid more than asset-allocation advisors even though it has long been known that asset allocation is the most important factor affecting investment performance and that stock selection is relatively unimportant—is in dire need of change.

Leaving aside the issue of remuneration levels, there will probably always be investors who are prepared to pay (either directly or indirectly) for high quality company research. What is not so clear, however, is whether sell-side analysts will continue to be the main producers of such reports. Institutional investors may feel that they are well-enough served by buy-side analysts or independent analysts, and retail investors by the information that is available free or at low cost on the Internet, even though such information may generally be inferior to the research traditionally provided by sell-side analysts.

In the United States, large securities brokers were obliged to distribute reports by independent research firms. This can be regarded as a policy to subsidize and facilitate the development of independent analysts and penalize sell-side analysts, intending to alter the structure of the investment research industry. Introduction of such a policy in Japan has not been proposed.

5) Whose job is it to regulate analysts?

Any consideration of the future for analysts in Japan needs to take account of one more factor: the pressure they face from bureaucrats and politicians. As we have seen, the FSA and the JSDA have strengthened controls and regulations to prevent sell-side analysts from providing investors with biased reports. However, it is not altogether clear whether their motive for doing so has been solely to safeguard the interests of investors.

The controversial ING report was probably not the first analyst's report to contain erroneous information. Nor was it the first time that the issue of firewalls between research and proprietary trading sections had been raised. The reason the FSA paid unprecedented attention to the errors in the ING report was partly the scale of the problem, but also partly the fact that Japan's bad debt problem was the focus of international attention at that time. If the FSA had not been so concerned about the decline in banks' share prices and the threat to the financial system, it would probably not have paid so much attention to a "sell" recommendation (albeit an extremely negative one) by a foreign securities company.

Japanese politicians and bureaucrats were critical of foreign securities companies and investors for making money by driving down the share prices of Japanese companies and banks, and accused foreign market participants, who they felt did not know what was going on in Japan, of undervaluing Japanese equities. This was particularly true since the beginning of 2001, when Japanese politicians and bureaucrats did their best to prevent increased speculation about Japan’s financial system after the G7 raised the subject of bad debt.

As well as taking action against ING, the FSA criticized the IMF for quoting market analysts’ views on the scale of Japan's bad debt problem and the authorities' response in its Article IV consultation report on Japan. In the FSA's view, it was irresponsible of a prestigious supra-national agency such as the IMF to quote the views of market analysts without confirming their accuracy.

This was not the first time that the Japanese government had taken a securities company to task for the content of one of its research reports. Reportedly, the authorities previously protested informally to the senior managers of securities companies about bearish stock market forecasts by strategists that work for them.

In other words, politicians and bureaucrats have sometimes objected to analysts' opinions for reasons other than safeguarding investor interests. Since securities companies are regulated by the FSA, analysts who work for securities companies may be subject to political or bureaucratic pressure, while independent analysts are not. If independent analysts became more influential, the authorities might be more tempted to take action against them for reasons other than safeguarding investor interests.

Be that as it may, the authorities should beware that such action would be an abuse of their power. If analysts need to be regulated, it should be to ensure that they fulfill their duty to investors as gatekeepers, and any rules should be enforced solely for that purpose and not to achieve some other public objective.

The next section takes up the general issue of regulating financial gatekeepers.

5. Lessons about Financial Gatekeeping from Japan's Experience

As the preceding discussion showed, the regulatory environment for financial gatekeepers in Japan has been strongly affected by developments in the United States. As a result, financial gatekeepers in Japan now face regulations very similar to those in the United States. There are, however, important differences in regulation between the two countries. For example, by and large, financial gatekeepers are less heavily regulated in Japan than in the United States. This section discusses whether such differences are justifiable. We start by asking why we need to regulate financial gatekeepers. Then we proceed to consider how gatekeepers should be regulated and who should regulate them. We examine the difference between American and Japanese regulation of financial gatekeepers in terms of the approaches to these questions.

1) Why do we need to regulate financial gatekeepers?

Securities regulations traditionally focused on securities transactions *per se*, on issuers, and on intermediaries like brokers, mutual funds, and stock exchanges. But now, regulators are focusing on financial gatekeepers, as we saw to be the case in Japan as well as in the United States.

When we consider the need to regulate financial gatekeepers, it is important to notice that we do not treat all financial gatekeepers equally. Different regulatory environments are being introduced or discussed for different types of financial gatekeepers.

In this section, I try to identify the factors that affect the extent of regulation of each type of financial gatekeeper by comparing the emerging regulatory environments in both the U.S. and Japan.

Comparing regulatory environments at this moment, we can see that accountants are the most highly regulated of the three types of financial gatekeepers; a specialized monitoring agency is dedicated solely accountants and laws and rules articulate provisions to keep their independence and avoid conflict of interests. With the exception of the not-so-clear qualifications for NRSRO status, rating agencies are relatively unregulated at present. Sell-side analysts are subject to greater oversight than rating agencies, but there is no specialized monitoring agency as there is for accountants. Actually, it is not analysts per se that are regulated, but the treatment of analysts' functions by securities brokers and dealers. Meanwhile, regulation of buy-side analysts and independent analysts has not come up in the current discussion.

Two variables explain the different regulatory environments for different financial gatekeepers. One is how much influence their information has on securities trades and the other is how uncertain and subjective their information is. Those two variables also represent two fundamental considerations in the need to regulate financial gatekeepers—the importance of protecting investors and the importance of protecting the freedom of information.

Those advocate greater regulation of financial gatekeepers would say that to fully protect investors it is not enough to regulate securities transactions; it is necessary to regulate the way information is provided for investors, or the conduct of financial gatekeepers. On the other hand, those who favor laxer regulation would point to the importance of freedom of providing (receiving) information for (by) investors. This is because increasing the amount of information market participants have increases market efficiency. Therefore, freedom of information provision is as important for markets as freedom of speech is for democracy. Besides, it is impossible or unrealistic to regulate the provision of all information for investment decision-making, since information comes in so many forms, is so prevalent, and is a common part of economic activity.

Given this close link between information and securities trading, regulating the provision of information is necessary to protect investors, since the current regime regulating securities transactions is based on the need to protect investors.

The risk that introducing additional regulation will constrain the provision of information is less where information is by-and-large certain and objective or where individual information providers with some professional expertise are likely to reach similar conclusions. This is because the variation in information is small and less valued when information is objective by nature.

If we compare accountants and sell-side analysts using those two variables, we can understand why accountants are more regulated than sell-side analysts.

Influence on trades

The core of securities regulation in both the United States and Japan is disclosure, with the quality of that disclosure endorsed by accountants. Thus, these gatekeepers are clearly important providers of information for securities transactions. In fact, securities laws in both countries already formally require the regulation of accountants, so the recent enhanced regulation just implements what the system was designed to do from the start.

Regulations on the conduct of securities brokers and dealers already regulate conduct of analysts employed or used by securities brokers and dealers. Certainly, sell-side analysts have great influence over trades, since the information they provide is intended from the outset to induce transactions. On this basis, we can say that sell-side analysts need to be regulated. At the same time, it is reasonable that they are not as tightly regulated as accountants. Sell-said analysts do not wield as much influence over trades as accountants because there are many analyst reports and other forms information available to investors.

Uncertainty and subjectivity

Since the information provided by accountants is prepared in accordance with GAAP, we can say that provision of this information is relatively objective and does not depend on the individual accountant who does the work. In this respect, regulation is not necessary to protect the provision of information, but, it is necessary to ensure investors that accountants follow these principles because accounting information is central to their trading decisions.

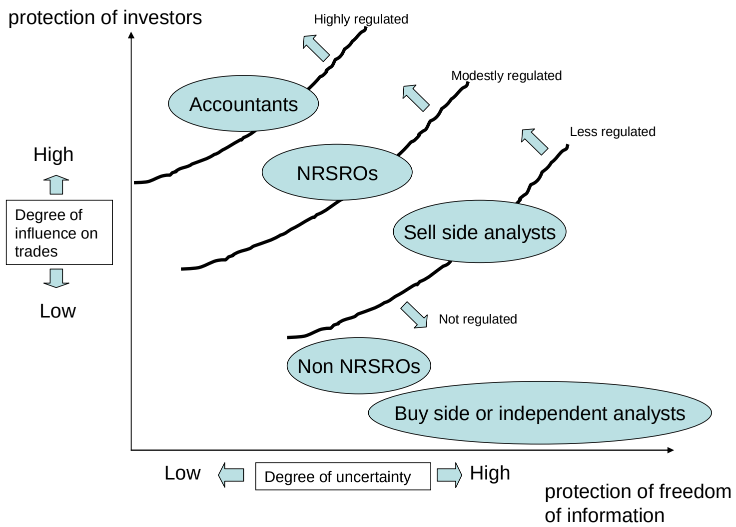
In contrast, the information provided by analysts is subjective and uncertain, and it is valuable for investors to have access to as wide a variety of information as possible.

For this reason, the necessity for regulatory interference with analysts is less than in the case of accountants.

By applying this kind of analysis to other financial gatekeepers, I arrived at Figure 2, which depicts how these two variables -influence on securities trades and uncertainty and subjectivity- affect the necessity to regulate different financial gatekeepers.

It is easy to understand why buy-side and independent analysts are not as regulated as sell-side analysts are. In terms of the subjectivity of the information they provide, all analysts are basically the same. But in terms of influence on trades, other types of analysts have much less influence on trades than ones employed or used by securities brokers and dealers.

Figure 2: The need to regulate financial gatekeepers explained by two variables



Source: NICMR

The location of rating agencies in the diagram needs explanation. Because various securities regulations refer specifically to the ratings of NRSROs, these rating agencies are closely involved in securities transactions and need to be regulated. Also, since investors do not have many alternatives to the ratings of NRSROs in evaluating fixed income securities, these ratings seem to have greater influence over transactions than the information provided by sell-side analysts. For this reason, it seems that NRSROs should be regulated more heavily than sell-side analysts, but since non-NRSROs do not have the same degree of influence in transactions, they should rather be treated like independent analysts who are not regulated.

In terms of uncertainty or subjectivity, rating information ranks higher than information provided by accountants, but lower than that provided by equity analysts since ratings only deal with credit risks and often focus only on whether or not an issue is investment grade. In this respect as well, NRSROs in the United States and designated rating agencies in Japan should be subject to more regulation than sell-side analysts.

The reality is that whether rating agencies are NRSROs or not, they are not regulated to the same extent as sell side-analysts. To explain this situation, we might consider the nature of the problems with financial gatekeepers that have occurred so far. Among the recent corporate scandals, in many instances accountants and sell-side analysts actually colluded with the firms they audited or researched to distort information disseminated to investors. But no such striking misdeeds by rating agencies have been reported. Moreover, since both accountants and securities brokers and dealers are already regulated entities, all that the authorities had to do in response to these scandals was to amend the existing regulatory framework. But, since rating agencies are not already regulated entities, regulators need to start by confirming the necessity for regulating them.

Lack of evidence of serious problems does not preclude the need for formal regulation of NRSROs because the information they provide is so influential in securities transactions. On the other hand, if NRSRO ratings were not required by various securities regulations and if the system designating certain rating agencies as NRSROs did not exist, then rating agencies would have much less influence and there would be less need to regulate them. The actual trend is moving in the opposite direction, however, toward using rating information in more regulations, such as Basel II.

As in the case of rating agencies, the location of each type of financial gatekeeper can shift depending on changes in their nature or in public policies. For example, today accounting information is becoming more and more subjective as fair-value accounting will require judgments over future cash flows. Also, investors may become less influenced by financial information and more by non-financial information. If such trends continue, there might less need for such rigorous regulation of accountants in the future.

It is also interesting to consider the possible location of other types of information-providers in this chart. For example, investment advisers in the United States are already subject to formal regulation through the Investment Advisers Act of 1940. This is understandable because their advice is so influential to securities trading even though it is rather subjective. At the same time, it is also reasonable that financial planners who do not refer to securities investments do not need to register as investment advisers, since they are remote from securities trading. Also, there should be a wide variety of creative financial advice available to suit the needs of various individuals.

The difference between the regulatory environment for financial gatekeepers in the United States and Japan can also be explained in terms of these two variables. For example, the fact that sell-side analysts in Japan are less regulated than in the United States is justified because they do not play as charismatic a role for individual investors and are not as involved in the investment banking business. Also, in Japan, earning outlooks are usually disclosed by firms as part of timely disclosure and analysts do not play an important role in pinpointing them as they do in the United States.

Accountants are less closely regulated in Japan than in the U.S., since Japan's CPAAOB only checks JICPA's reviews of audit firms whereas the U.S. PCAOB itself performs checks of audit firms. Also, the rotation period for audit staff is only seven years in Japan instead of five years like in the United States. Japan’s more lenient treatment of accountants is hard to explain according to our framework, since accounting information is as influential to securities trading in Japan as it is in the United States. In the wake of recent accounting scandals in Japan, the regulatory environment of accountants in Japan may well be tightened.

2) How should financial gatekeepers be regulated? (1) Competition and availability

In the previous section, we discussed the necessity for regulating certain financial gatekeepers. The next point is to consider how financial gatekeepers should be regulated if regulation is justified. We focus on two issues that seem to be important when considering optimal regulation of financial gatekeepers; one is competition and availability and the other is conflicts of interest.

In general, the optimal number of service providers could be determined by market forces if there is a free and efficient market for the service. But with some financial gatekeepers, regulation to protect investors may restrict new entries, for example. Therefore, we could not just let market forces decide the number of each type of financial gatekeeper and the actual number might be less than optimal.

Limited competition and availability among a certain type of gatekeeper will tend to increase this group’s influence on trades. Also, the potential for problems with one financial gatekeeper will increase the fewer gatekeepers in the same area. These observations suggest that there is greater need for regulation if competition among and availability of financial gatekeepers is limited. But stricter regulation could result restricting the supply of financial gatekeeper services and just aggravate the problems.

On the other hand, sufficient numbers of financial gatekeepers and competition among them could help keep potential problems in check through market discipline on their behavior. In which case, there will be less need for regulation.

Therefore, even if a certain type of financial gatekeeper should be regulated, it is at least necessary to design the regulation in a way that would not reduce the availability of and competition among these gatekeepers. Moreover, the better policy might be to actively promote the availability of and competition among these gatekeepers.

One of the Japanese government's policy objectives is to foster the development of a financial system that depends less on the banking system and more on financial markets. At the moment, however, there is a (relative) shortage of accountants in Japan, so one of the government's aims is to increase their number. The title "CPA" in Japan is a state qualification, and government has traditionally controlled the numbers entering the accounting profession by controlling the number of candidates who pass the state examination. But attempting to relieve the shortage of accountants by increasing the number of successful candidates in a short space of time could lead to a drop in quality. Moreover, those who have already qualified as CPAs have had a vested interest in opposing a sharp increase in the number of new entrants.

Although reform of the accounting profession in Japan has included attempts to increase the number of new entrants, the increased regulatory burdens placed on accountants make the profession less attractive and make it difficult to solve the problem of availability. For example, the rules on auditors' non-auditing activities have been tightened at the same time as their auditing responsibilities have been increased. This has made it increasingly difficult for auditing firms to turn a profit. Japan's leading auditing firms have already formed alliances with their counterparts in the United States, and the auditing business is increasingly becoming an oligopoly just like in the United States.

Unless companies appreciate the value of well conducted audits and are prepared to pay what they are worth, there is a risk of a shortage of auditors. Therefore, we need to keep a careful eye on how the recent changes in the rules governing auditors in both Japan and the United States affect the availability of auditing services[11].

When among one type of gatekeeper, some providers are regulated (e.g., NRSROs and sell-side analysts) others are not, the market should determine the demand and supply of those that are not regulated—just as for any other normal good or service. And for the providers that are regulated, we should examine whether or not the regulation hampers availability and competition.

In the case of rating agencies, the system of designated rating agencies in Japan hampers achievement of the optimal supply of players. Abandoning this system might reduce the need to regulate rating agencies since their influence on trades will decline and competition and market discipline will increase.

The recently adopted policy mix in the United States, penalizing sell-side analysts with relatively harsh regulation and subsidizing independent analysts, implies that sell-side analysts were judged to be in oversupply and independent analysts were undersupplied under market forces, making policy intervention necessary.

If it is necessary for the authorities to intervene to foster independent research in the United States, the world's largest capital market, then it would appear that they would need to do even more in smaller and less developed markets, such as Japan, if the dominant position of sell-side analysts is to be reduced. A decline in market demand for and the market value of sell-side analysts in itself is unlikely to be enough to boost demand for independent research. This raises the question whether governments in countries other than the United States should actively pursue policies to foster the development of independent research.

Generally speaking, if we cannot just let market forces achieve the optimal supply of financial gatekeepers, there are several policy alternatives. The government might fully control the number of new entries, or give subsidies to encourage new entrants, or even control fee levels for certain financial gatekeepers to keep the industry profitable. Another, less interventional, approach would be to give financial gatekeepers as much freedom as possible so that they could more easily stay in

[11] There is another aspect to the availability problem for auditors. As we discussed, the increasing legal liability and financial settlements facing auditors could jepardize the Big Four American accounting firms, and such a threat may become real in Japan as well in the future.

business and there would be more room for new entrants. For example, the government could allow financial gatekeepers to adopt a wide range of business models and keep enough revenues from the non-financial gatekeeper business they generate by utilizing their capacity as financial gatekeepers. Such an approach seems difficult to follow because is raises concern over conflicts of interest.

3) How should financial gatekeepers be regulated? (2) Conflicts of interest

One pillar of regulation over financial gatekeepers is to avoid conflicts of interest. Conflicts of interest are inherent in most financial gatekeepers, since it is difficult to collect fees from the users of their information so they depend on other sources of revenue. That is, accountants depend on fees from the firms being audited, rating agencies depend on fees from issuers being rated, and sell-side analysts depend on fees from securities business.

In both the United States and Japan, accountants are prohibited from providing both audit and non-audit services to the same client; sell-side analysts are barred from involvement in investment banking business; and rating agencies are criticized for depending on fees from issuers who are to be rated.

There might be various ways to protect investors from the damage caused by conflicts of interest. What is important is to control the damage and not necessarily to limit the freedom of adopting various business models or organizational structures because they could possibly induce conflicts of interest.

If we look at financial regulation as a whole, we can observe two trends of reform heading in opposite directions when it comes to conflict of interest. In the area of banking regulation, the walls separating banking and securities businesses that had been established to avoid conflict of interest have been lowered. On the other hand, many of the provisions of SOX emphasize the importance of independent agents in various areas to avoid corporate fraud and conflict of interest.

Benston et al. criticize the U.S. decision to prohibit accountants from providing both audit and non-audit services to the same company.[12] We might also question whether it was necessary to completely ban analysts' involvement in investment banking business. Instead of imposing strict separation of businesses, especially where availability and competition are limited, we might allow financial gatekeepers more freedom in their business portfolios and organizational structures and enhance the system to monitor potential abuses. This is exactly the model regulators are following in dealing with conflict of interest issues in banks' securities business.

4) Who should regulate financial gatekeepers?

So far, it has seemingly been taken for granted that the regulator of financial gatekeepers is a government organization. But, especially as Japanese experience suggests, governments are not necessarily guardians of investors and they sometimes fail to regulate financial gatekeepers in the interest of investors.

[12] Benston, et. al. (2003)

This is because governments and government authorities have their own interests. For example, governments are issuers of bonds and shareholders in companies being privatized. Also, a banking regulator's interest in avoiding financial panic may put it at odds with financial gatekeepers that reveal weaknesses in the banking system. Besides, political pressure may distort regulators' decisions, as happened with the U.S. regulators' decision on the accounting treatment of stock options.

The ideal might be an organization solely devoted to protecting investors that was politically independent and separated from other government policy objectives. Such an organization would be comparable to a central bank which is narrowly focused on monetary policy and legally guaranteed political independence. Such an organization should also be financially independent.

Litan argues that the United States should have utilized the SEC to deal with the problem of conflict of interest among accountants, instead of establishing the PCAOB.[15] Financial independence of regulators is certainly an issue in Japan. The CAPAAOB (Certified Public Accountants and Auditing Oversight Board) is under the authority of the FSA and is financed by taxes, and so could be influenced by other policy objectives of the FSA[16] or of politicians. Also the Japanese accounting standards-setting body, ASBJ, is barely financed by corporate membership fees and publications, unlike its U.S. counterpart, FASB, which is now financially supported by PCAOB.

In Japan, some argue for introducing a U.S.-type SEC, but others question having separate regulators for securities markets, the banking system, and insurance in this day of financial conglomerates.[17] Japan is also actively debating the role of various SROs.

The issue of who should regulate financial gatekeepers, then, is bound up with the structure of the regulatory system, a topic which is beyond the scope of this paper.

[15] Benston et.al. (2003).
[16] Japan's FSA is not only a regulator for investor protection but also a banking and insurance supervisor.
[17] Some Americans do not seem to be satisfied with the current regulatory structure as seen in the GAO report, *Financial Regulations*, October 2004.

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