RECHTSPRECHUNG / CASE LAW

The Principle of Compatibility in Soliciting Stock Investment
Judgment of the Supreme Court, 14 July 2005

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The plaintiff is a company whose business is the processing and wholesaling of fish in a regional fish market. It was set up as a result of the amalgamation of five existing wholesale companies, with a capital of 120 million yen, in 1984. The annual turnover is between 20-30 billion yen. The company was given a low-interest loan from the local government. The management decided to invest *part* of this loan which was not in use. The investment began with the opening of an account with the defendant, a major securities company, and the placing of 500 million yen in 1984.

Persons within the company who were managing the investment were the president and the managing director. The former, by 1983, was experienced in investment in stocks including trading on credit, futures trading and trading in warrant bonds. The latter had general knowledge and experience of stock trading.

Transactions involving the plaintiff's account encompassed not only real stocks, but also trading in government bond futures, foreign currency denominated warrant bond futures, and stock futures. The total value of transactions reached 20-40 billion yen annually.

In 1989, trading in Nikkei Stock Index Options, which is a stock price index options trade, began at the Osaka Stock Exchange. The employee who represented the defendant in relation to the plaintiff at that time explained the system of trading to the people in the plaintiff company and informed them that while the loss, when buying options, is limited to the amount of investment, when selling options, the loss can be indefinite. The plaintiff decided to commence stock price index option trading. In the first round of transactions, the plaintiff made a loss and decided to ceased trading. The transaction was renewed later, and after 10 transactions, some profits were made, but trading was again terminated due to the illness of the representative of the defendant.

The share prices sharply fell in 1990, and as a result, the plaintiff suffered unrealised loss exceeding one billion yen. In order to regain profits under such circumstances, the plaintiff resumed trading in stock price index options. When the plaintiff lost 20 million yen, the trading was again terminated. In 1992, when the representative of the defendant changed, the trading was resumed. There were 199 transactions altogether and the plaintiff incurred a loss of 200 million yen.

The plaintiff's purpose for the investment was not merely to maintain the level of the net assets, but to maximise profit even if doing so involved some risk, rather than investing in low-risk products.

The plaintiff brought an action in tort against the defendant, arguing that the defendant had acted wrongfully in that 1) the representative of the defendant company acted against the principle of compatibility, 2) the person failed to fulfil his duty to contain the loss of the customer to the minimum, and 3) the person failed to give proper explanations in advance to the customer.

After the first instance court dismissing the claim, the Tokyo High Court ruled in favour of the plaintiff and ordered the defendant to pay 125 million yen, which was around 10% of the amount of compensation sought by the plaintiff. The court found that since selling call or put options may incur an indefinite amount of loss, in principle, encouraging customers who do not have any knowledge, experience or capability to avoid the risk to invest in them would generally be against the principle of compatibility. People in the plaintiff company may have had sufficient knowledge and experience in ordinary stock investments, but cannot be regarded to have had sufficient knowledge, experience or capability to contain or avoid the risk in selling options. Therefore, the court found the acts of the defendant to be against the principle of compatibility and ordered the defendant to pay compensation.

The Supreme Court, however, quashed this judgment and remanded the case to the Tokyo High Court. The Securities and Exchange Law before the 1998 amendment referred to the principle of compatibility, *i.e.* the securities companies should not solicit customers who are unsuitable for an investment in the light of their knowledge, experience and financial state (after the 1998 amendment, the principle is explicitly provided for in Article 43, para. 1). The Supreme Court ruled that if a securities company representative solicits transactions which is substantially in breach the compatibility principle, such as actively encouraging the customer to effect transactions involving excessive risk against their intention and financial state, it is unlawful under the law of tort. When determining the compatibility of the customer, it is not sufficient merely to consider the general and abstract risk involving, *e.g.* the sale of options, but the specifics of the product, such as whether the said option is listed or not, must be considered, and in relation to this, the investment experience on the part of the customer, their knowledge of stock transactions, their intention in investing, the state of their finances etc. should be taken into account.

In the present case, Nikkei Stock Index trading is one of the option tradings as provided for in the Securities Exchange Law and different from other products such as over the counter trade stocks index options, is expected to have a wide range of investors participating in the trading and is actually listed in the stock exchange. Sufficient safeguards and provision of information are ensured. Nikkei Average Stock Index trading may be a high risk investment, but this does not in itself mean that ordinary investors are not compatible with the product.

According to the facts established by the original instance court, the plaintiff has more than 2 billion yen of financial resources and intended to invest a substantial part of it. The persons responsible for the investment in the plaintiff company had gradually accumulated knowledge and experience over the years. In the five years up to 1989 when the plaintiff company began trading in the Nikkei Stock Index Options, the company had traded in futures and other products for tens of billions of yen. Even before the last round of transactions in the Nikkei Stock Index Options, the plaintiff company had traded in the same product in a restrained manner. It cannot be said that the plaintiffs were not capable of taking risks and should not have entered the market. Therefore, the act of the representative of the defendant company in soliciting investment from the plaintiff company, cannot be regarded as an excessive deviation from the principle of compatibility, and thus, does not constitute a tort.

There was a supplementary opinion regarding the duty of the securities company to give guidance and advice. According to this judge, securities companies have a duty under the doctrine of good faith and fair dealing to give guidance and advice when the transactions by the customer become disproportionately inclined to selling options.

There have been lower court judgments to the effect that if the method and manner of solicitation by a securities company is significantly incompatible with the purpose of investment, the state of finance and experience of the investor and are socially unacceptable, there is a breach of an obligation or an act of tort on the part of the securities company.

This judgment is the first on this problem by the Supreme Court. The fact that the Court ruled that a serious breach of the principle of compatibility comprises a tort on the part of the securities company is a significant development. In this particular case, the Court did not acknowledge the liability of the securities company, but in the light of the expertise of the investors in this case, this is probably justifiable.