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Briefing Note

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Recent and potential changes to the Japanese Insider Trading Regulations

As part of the amendments to the Financial Instruments and Exchange Act (the "FIEA") promulgated on 12 September last year (the "Amendment") revisions were made to the provisions of the FIEA regarding insider trading and the related monetary penalty (*kachoukin*) system (the "Insider Trader Regulations"). The enforcement date of the Amendment will occur sometime before 12 September 2013 and will be specified by Cabinet Office Ordinance.

Following the Amendment, the "Working Group on the Insider Trading Regulations", a working group of the Financial System Council (the "FSC"), published a report titled "Development of Systems concerning the Insider Trading Regulations based on Recent Violations and Financial and Corporate Practices" (the "2012 Report"). In response to the 2012 Report, on 16 April 2013, a bill to further amend the FIEA (the "2013 Draft Bill") was submitted to the Diet.

In this Client Briefing we provide an outline of the Amendment focusing on the upcoming changes to the Insider Trading Regulations. We also highlight potential changes to the Insider Trading Regulations recommended in the 2012 Report and proposed by the 2013 Draft Bill.

Outline of the upcoming changes to the Insider Trading Regulations pursuant to the Amendment

Partial exemption from the Insider Trading Regulations in the case of a company reorganisation

Under the existing law, transfers of listed shares pursuant to a "specific type of corporate reorganisation" (*tokutei shokei*)[1] are subject to the Insider Trading Regulations whereas transfers of listed shares pursuant to a "comprehensive corporate reorganisation" (*hokatsu shokei*)[2] are not. In addition, a transfer by a company of its listed shares from its treasury stock as consideration for a transaction forming part of a company reorganisation is subject to the Insider Trading Regulations whereas a transfer by a company of its own newly issued listed shares is not. These distinctions under the existing law are

1 For example, a business transfer.

2 For example, a merger and corporate divestiture.

not necessarily logical and they result in the Insider Trading Regulations being applied in circumstances where the risk of insider trading is low. The Amendment provides for a more uniform application of the Insider Trading Regulations to share transfers undertaken as part of a company reorganisation.

From the enforcement date of the Amendment, transfers of listed shares as part of a company reorganisation will be broadly subject to the Insider Trading Regulations. However, under the revised law, if:

(i) the ratio of the amount of listed shares (based on book value) to the amount of assets transferred pursuant to the corporate reorganisation is less than a certain specified percentage[3]; or

(ii) the details of the corporate reorganisation are concluded at a board of directors' meeting before non-public material information regarding the issuer of the listed shares becomes known; or

(iii) the listed share transfer is made pursuant to an "incorporation-type corporate divestiture" (*shinsetsu-bunkatsu*)[4] (i.e. a "joint incorporation-type corporate divestiture" (*kyodo-shinsetsu-bunkatsu*)[5], being a transaction between each splitting company, is not included),

the relevant transfer of listed shares undertaken as part of the company reorganisation will not be subject to the Insider Trading Regulations.

Under the existing law, if a company allots listed shares from its treasury stock as consideration for a company reorganisation, the company needs to comprehensively review all non-public material facts (actions) relating to it as the Insider Trading Regulations could apply. Such a review is expensive. Because the person to be allotted the treasury stock will have already come to know much of the company's information during the course of its due diligence there would be a low risk of such information being used for insider trading. Thus, from the enforcement date of the Amendment, the Insider Trading Regulations will no longer apply to the allotment of listed shares as consideration for a company reorganisation.

Expanding the scope of the monetary penalties applicable for violations of the Insider Trading Regulations committed by a Non-Regulated Entity trading for third party accounts

Under the existing law, a person or entity who is not a financial instruments business operator or registered financial institution (a "**Non-Regulated Entity**") is not subject to any monetary penalties if such Non-Regulated Entity is found to have committed insider trading when transacting for a third party account, for example, a client account. As a result, a Non-Regulated Entity who manages client assets could engage in insider trading when transacting for a client's account, but the Non-Regulated Entity itself would not be subject to any monetary penalties for such violation. The Amendment expands the scope of the monetary penalties for insider trading so that the monetary penalties imposed under the FIEA will apply to insider trading committed by a Non-Regulated Entity when it is transacting for a third party account.

Potential changes to the Insider Trading Regulations recommended by the FSC in the 2012 Report and the 2013 Draft Bill

The 2012 Report considers the following issues:

(i) regulation of disclosure of information and inducement to trade;

(ii) reform of monetary penalties applicable for violations of the Insider Trading Regulations relating to third party accounts;

3 The percentage is expected to be 20% and will be specified in the relevant Cabinet Office Ordinance.
4 A company split whereby a new company incorporated pursuant to the corporate divestiture succeeds to the rights and obligations of the company which is the subject of the split.
5 An incorporation-type corporate divestiture whereby the new company succeeds to the rights and obligations of two companies which are jointly split.

(iii) reform of the Insider Trading Regulations to reflect recent financial and corporate practices; and

(iv) stakeholder co-operation to prevent insider trading.

Some of the recommendations in the 2012 Report have been reflected in the 2013 Draft Bill as discussed below.

Regulation of disclosure of information and inducement of insider trading

The existing Insider Trading Regulations restrict the sale and purchase of shares by a corporate insider (*kaisya-kankeisya*) or by a "first recipient of information" (*daiichiji-joho-juryosya*) who has non-public material information of the relevant company. The 2012 Report proposes that the Insider Trading Regulations be revised so that, in principle, both of the following are regulated:

(i) the disclosure of the non-public material information itself; and

(ii) the act of inducing another person to trade where there is no actual disclosure of non-public material information but where the disclosing party is shown to be in a position to have known such information.

The 2012 Report recommends that, in order to avoid interfering with the regular business activities of a listed company in disclosing its information to investors, such disclosures or inducements to trade should only be subject to the Insider Trading Regulations where:

(a) the disclosing party discloses the information with the purpose of the recipient conducting insider trading on the basis of such information; and

(b) the disclosure of information or inducement to trade forms an element of the decision to invest or trade which results in an actual transaction.

The 2013 Draft Bill provides that a corporate insider (for example, a director or employee of a listed company or a securities company acting as lead manager) who has non-public material information will be prohibited from disclosing such information to a third party or inducing a third party to trade with the intention of the third party conducting insider trading and making a profit. If insider trading actually occurs based on the corporate insider's disclosure or inducement, the corporate insider can be charged with a criminal offence or have monetary penalties imposed on it.

The 2012 Report also proposes that in respect of violations of the Insider Trading Regulations by brokers of listed shares:

(i) monetary penalties should be determined according to a more effective mechanism designed to deter violations of the insider trading laws (for example, calculation of monetary penalties should be based on or reflect continuing brokerage fees paid by an institutional investor); and

(ii) the names of directors and employees of the broker involved in the violation should be made public in order to alert others to such conduct.

In the recent insider trading cases, it was alleged that hedge fund managers often demanded that they be provided with a "scoop" by securities companies in respect of initial public offerings of shares. The 2012 Report points out that this behaviour facilitates disclosure of information which leads to insider trading. The 2012 Report proposes that if a person demands non-public material facts by exploiting its position and, as a result, insider trading is conducted by a hedge fund, the person who has abused its position should be publicly named so as to alert others to their behaviour.

The 2013 Draft Bill provides that the names of persons involved in a violation of the FIEA may be made public if necessary and appropriate for the public's benefit and the protection of investors.

Reform of the monetary penalties applicable for violations of the Insider Trading Regulations relating to third party accounts

An example of a situation when insider trading on behalf of a third party may arise is where an investment manager engages in insider trading when entering into transactions on behalf of a client account. The 2012 Report points out that investment managers, whose fees are often based on the success of the portfolio they manage, may receive higher management fees from a client by engaging in insider trading, thus encouraging violations of Insider Trading Regulations. The 2012 Report suggests that one-off penalties based on management fees charged by the investment manager for a specific transaction which constitutes insider trading are not a sufficient deterrent and that the calculation of monetary penalties for investment managers who breach the Insider Trading Regulations when transacting on behalf of a client should be based on the aggregated amount of management fees charged by the investment manager to the client over a certain period.

The 2013 Draft Bill sets the monetary penalties applicable to investment managers for violations of the Insider Trading Regulations relating to third party accounts at three times the amount of management fees charged by the investment manager during the month the violating transaction was carried out.

Reform of the Insider Trading Regulations to reflect recent financial and corporate practices

Under the existing law, a person falling within the definition of a "Person Concerned with a Tender Offeror" is subject to the Insider Trading Regulations. The definition of a "Person Concerned with a Tender Offeror" does not specifically include the target company the subject of the tender offer or its directors or employees unless there is a confidentiality agreement in place between the offeror and the target company in connection with the tender offer. Most tender offers in Japan are friendly acquisitions implemented on the basis of an agreement between the offeror and the target company in advance of the tender offer. Consequently, the target company and its directors and employees are likely to have knowledge of the non-public fact of the tender offer itself. In light of this background, the 2012 Report proposes that the target company and its directors and employees should be specifically included in the definition of a "Person Concerned with a Tender Offeror" and subject to the Insider Trading Regulations. The 2013 Draft Bill includes the target company the subject of a tender offer and its directors and employees in its definition of a "Person Concerned with a Tender Offeror".

Under the existing law, if a person or entity who makes a tender offer to a listed company intentionally conveys the (otherwise non-public) fact of the tender offer to another potential buyer, the other potential buyer may be prevented from buying the target company's shares. The 2012 Report suggests that, so long as investor confidence in the fairness and soundness of the securities market is not undermined, a transaction by a potential buyer in receipt of such information should not violate the Insider Trading Regulations. The 2012 Report also suggests that where there has been a significant lapse of time between the relevant information being disclosed to the recipient, the value of such information may have deteriorated and may be unlikely to influence investment decisions. In that case it would be appropriate for the recipient of the non-public information to carry out the transaction. The 2013 Draft Bill provides that the Insider Trading Regulations would not apply to a potential buyer with knowledge of the prior tender offer if (i) the potential buyer describes the fact of the prior tender offer in the notification of tender offer that it submits upon commencing its tender offer, or (ii) 6 months passes from the potential buyer becoming aware of the prior tender offer.

A "Transaction Between Knowing Parties" is a transaction between certain prescribed parties who have knowledge of non-public material information of a listed company. Under the existing law, the "Transaction Between Knowing Parties" exemption is only applicable to transactions between a company insider and the first recipient of non-public material information. The 2012 Report recommends that the scope of the Transaction Between Knowing Parties exemption be expanded to include transactions between the first recipient of the non-public material information and a subsequent second recipient who receives the non-public material information from the first recipient. This should make it easier for a major shareholder (in this situation, the first recipient of information) to conduct a block trade outside of the stock exchange in order to decrease its shareholding in the company to which the non-public material information relates. The 2013 Draft Bill reflects this proposal by extending the Transaction Between Knowing Parties exemption to transactions between the first recipient of non-public material information and a subsequent second recipient of the information.

Under the existing law, a transaction implemented independently and without knowledge of non-public material information of a listed company falls outside the Insider Trading Regulations if the transaction constitutes an "Agreement Before Obtaining Information" or a "Plan Before Obtaining Information". These terms are defined in the relevant Cabinet Office Ordinance. The 2012 Report recommends that a more comprehensive form of the exemption be provided for in the law so as to better balance the need to allow a wider range of transactions to fall within the exemption against the risk that an agreement or a plan subject to the exemption could be subsequently fabricated.

Stakeholder co-operation to prevent insider trading

The 2012 Report highlights that in order to prevent insider trading, in addition to having appropriate legal regulations in place, relevant stakeholders including the Financial Services Agency, the Securities and Exchange Surveillance Commission, the financial industry and financial instruments exchanges must fulfil their roles and work together towards creating a market environment where unfair trading is prevented.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

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