

Significant changes to the Japanese short selling regulations

On 21 August 2013, the Financial Services Agency of Japan (FSA) published its final version of the Cabinet Order and the relevant subordinate regulations intended to amend the Japanese short selling regulations. The amendments, which will take effect on 5 November 2013, include:

- Significant changes to the reporting and disclosure of short selling positions including, a widening of the scope of transactions subject to the requirements and changes to the applicable reporting and disclosure thresholds;
- Significant changes to the uptick rule; and
- The introduction of anti-avoidance type provisions relating to the ban on naked short selling.

This client briefing explains the new regulations focusing on those amendments that we consider particularly important for foreign investors.

Changes to the reporting/disclosure of short selling positions

Under the current regulations, a seller of listed securities is required to report to the Japanese stock exchange through its securities broker if the seller holds a short sale position at or above 0.25% of the outstanding number of the securities. Such information provided by the seller to the Japanese stock exchange is disclosed to the public. After the amendments take effect, the reporting threshold will be reduced to 0.20% while the public disclosure threshold will be increased to 0.50%. These reporting and disclosure requirements, which are currently temporary measures adopted in 2008, will be permanent measures.

In addition, the transactions subject to the reporting and disclosure requirements will be expanded. Unfortunately, the extent of the expansion is not entirely clear. Under the current regulations, short sales subject to the reporting and disclosure obligations are limited to those short sales executed on a Japanese stock exchange. After the amendments take effect, this limitation will no longer apply. It is clear that short sales executed on a proprietary trading system in Japan (which is similar to a multilateral trading facility in Europe or alternative trading system in the US) and short sales executed as an OTC transaction in Japan will be subject to the reporting and disclosure requirements. However, it is not clear whether OTC transactions executed outside of Japan or transactions executed on a foreign stock exchange or a foreign system equivalent to a proprietary trading system will be subject to the reporting and disclosure requirements. We believe that the new reporting and disclosure requirements are likely to apply to at least short selling of securities issued by a Japanese issuer whose main market is Japan. However, it is not clear, for instance, whether the new regulations apply to short selling at a foreign stock exchange of interests in an ETF established outside of Japan which is listed on both the foreign stock exchange and the Tokyo Stock Exchange (where the main market is not Japan).

Hence, foreign investors should (i) reflect the new thresholds applicable from 5 November 2013 in their reporting and disclosure systems and procedures and (ii) confirm, prior to executing a short sale transaction, whether the relevant securities to be sold are listed in Japan regardless of the place (in Japan or outside Japan) and the form (at a stock exchange or OTC) of execution of the transaction.

Changes in the uptick rule

Short selling at a stock exchange at a price lower than (or equal to) the latest market price is prohibited (the "uptick rule"). After the amendments take effect, the uptick rule will be modified by the introduction of a "trigger feature". Roughly speaking, this means the uptick rule will only apply for 2 business days when the price goes down 10% from the closing price of the preceding business day.

Currently the uptick rule applies to short selling transactions executed on a stock exchange. After the amendments take effect, the uptick rule will also apply to short selling transactions executed on a certain proprietary trading system – in this sense, the uptick rule will be tightened.

Other changes

The amendments involve various other changes to the current regulations. For example, the amendments include anti-avoidance type provisions relating to the ban on naked short selling. Currently, the ban on naked short selling applies only to short selling at a stock exchange (and from 5 November it will also apply to short selling at a certain proprietary trading system). In theory, if a person sells shares to a securities broker (off-exchange) and the securities broker then sells the shares at a stock exchange as principal (not as broker), on the face of it, the transaction would appear to be outside the scope of the ban on naked short selling since the original holder is not selling the shares at the stock exchange and the securities broker has agreed with them to buy the shares (i.e., the short sale is not "naked"). However, such transactions may be considered to be inappropriate from a viewpoint of the regulator if the original holder had the intention to evade the ban on naked short selling by having the securities broker act as principal. The amendments include a provision to the effect that the sale in these circumstances by such securities broker should be categorised as naked short sale if the customer and the securities broker are in collusion with each other.

Contacts

If you would like to know more about the subjects covered in this publication or our services, please contact:

Masayuki Okamoto
Partner

T: +(81 3) 5561 6665
E: masayuki.okamoto@cliffordchance.com

Yasuyuki Takayama
Counsel

T: +(81 3) 5561 6621
E: yasuyuki.takayama@cliffordchance.com

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Clifford Chance, Akasaka Tameike Tower, 7th Floor, 2-17-7 Akasaka, Minato-ku, Tokyo 107-0052, Japan

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