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INSIDER TRADING

Insider Trading Enforcement in Japan

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Over the past three years, the imposition of increasingly significant sanctions against major investment banks and other firms for insider trading violations has highlighted the Securities and Exchange Surveillance Commission's ("SESC") increasing focus on enforcement of Japan's insider trading rules. These enforcement actions have increased gradually over the past decade as part of the Japan Financial Services Agency's ("JFSA") efforts to make Japanese public securities markets "safer" for individual investors in line with its "Better Market"[1] and "Better Regulation" initiatives.[2]

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The content of this article is necessarily summary in nature and should not be viewed as legal advice. It is prepared as background information for the international legal community and other interested persons. The explanations herein should not be acted upon without appropriate legal advice from a qualified Japanese lawyer.

This Article provides a brief overview of Japan's insider trading rules and enforcement actions by regulators over the past decade. It will not review the more heavily sanctioned activities categorized generally as "market manipulation," but those developments may be considered in a future article.

1. *Basic Prohibition.*

The basic prohibition on trading on insider information in Japan is set forth in Article 166 of the Financial Instruments and Exchange Act (Law No. 25 of 1948, as amended, the "FIEA") which states:

> A person listed in any of the following items (hereinafter referred to as a "Corporate Insider" in this Article) who has come to know a Material Fact Pertaining to Business or Other Matters of a Listed Company, etc. in a manner as prescribed in the respective items shall not make sales or purchase, ... of Specified Securities, etc. pertaining to the Listed Company, etc. before the material facts pertaining to business or other matters are Publicized.[3]

Article 166 of the FIEA goes on to provide that the restriction applies to a "Corporate Insider" for one year after the person is no longer a Corporate Insider.[4]

2. *Who Are Corporate Insiders*?

Corporate Insiders are defined to include various categories of persons that are covered by the prohibition. These include:

> any officer . . . . agent, employee, or other personnel . . . .. in the employment of said listed company, etc. (including the parent company or subsidiary company of said listed company, ...) — if the person becomes aware of the same through the person's respective duties.[5]

Article 166 of the FIEA also defines other specific groups that may become insiders under certain conditions. These include company shareholders (i.e., share-

[1] See http://www.fsa.go.jp/en/policy/bmi/index.html.
[2] See http://www.fsa.go.jp/en/policy/iqfrs/index.html.
[3] See http://www.fsa.go.jp/common/law/fie01.pdf at 470.
[4] See http://www.fsa.go.jp/common/law/fie01.pdf at 470.
[5] See http://www.fsa.go.jp/common/law/fie01.pdf at 470.

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holders that hold 3 percent or more of a company's shares), persons with administrative authority over the company, parties contracting (or negotiating an agreement) with the issuer and persons working for firms that contract (or negotiate an agreement) with the issuer.[6]

3. *Coverage of Tippees of Corporate Insiders*

In addition to the corporate insiders certain persons who learn information from a Corporate Insider (i.e., ''Tippees'') are prohibited from trading *specified securities* of a listed company (or otherwise assigning or accepting the same for value or engaging in a derivatives transaction in respect of such securities).[7]

A Tippee includes any person who receives the material information from a Corporate Insider, as well as any officer or employee of a company at which such person works, in circumstances where the received material information was obtained in connection with that person's performance of his or her duties.

It should be noted that (unlike in some other jurisdictions) the trading prohibition will only apply where the Tipper has demonstrated an intention to deliver the material information to the Tippee. Although there has been some discussion of expanding the scope of covered Tippees in recent years (i.e., whether to expand the definition of the Tippees to a second or more remote Tippee), currently only direct Tipees are sanctioned under the FIEA.

However, second degree and other remote Tippees may incur secondary liability as accomplices of the Corporate Insider and initial Tippee.

Also, it should be noted that under revisions to Japan's insider trading rules in June 2013, both the disclosure of insider information by a Corporate Insider as well as the making of trading recommendations is prohibited if the Corporate Insider intends to cause the Tippee to trade and make a profit using the insider information received.

Furthermore, while the foregoing conduct of the Corporate Insider is prohibited under the new regulations, in order for such conduct to result in the imposition of an administrative penalty or criminal charge against the Corporate Insider, it must be shown that the Tippee did in fact trade using the insider information received from the Corporate Insider.

4. *What Securities Are Covered*?

As noted above, Japan's insider trading rules apply only to ''specified securities'' in a ''listed company.'' The term ''specified securities'' is a subset of the types of securities listed in the definition of ''securities'' included in Article 2(1) of the FIEA. These securities are defined in Article 163(1) of the FIEA and relevant subordinate regulations[8] and include among others, all classes of equity securities, private or public bonds, depositary receipts, and options on common shares (as defined in the FIEA).

Thus, in general, derivative transactions in these securities of a listed company are also prohibited under the Article 166(1) of the FIEA when based on insider information. In principle, only the securities of the companies that are ''listed'' on an exchange in Japan[9] are covered by Japanese insider trading rules.[10]

5. *When Is Information ''Material''*?

The prohibition in Article 166(1) of the FIEA only applies the prohibition to trading etc. based on ''material'' information of a listed company, or subsidiary of a listed company, that is not public (''material non-public information'').[11] Article 166(2) of the FIEA provides a non-definitive list of types of information that can be considered ''material.'' These are divided into two major categories:

1. The first category relates to ''material decisions by a company''[12] and includes issuances of shares or warrants or disposition of treasury shares, capital reductions, share splits, dividend payments and share exchanges, mergers, spin-offs, business acquisitions and fixed asset purchases, dissolutions, product commercialization decisions, business tie-ups, subsidiary consolidations, business closures, insolvency petitions, share cancellations and delisting applications.

2. The second category relates to ''new circumstances affecting a company's performance'' and includes business losses from disasters or business operations, major shareholder changes, delisting events, certain litigation matters, administrative sanctions or license suspensions, creditor or issuer initiated insolvency petitions, clearing failures or dishonoring of a note at a note clearinghouse,[13] parent company insolvencies or shareholding changes, termination of major business relationships, and new resource discoveries.[14]

There is also a ''basket clause'' intended to cover information not specifically identified in the regulations but that would likely influence investor decisions.[15] As a result, in practice, compliance professionals assume that if the information is such that a trader might view it as relevant to a trading decision, it should be viewed as ''material'' in the Japanese trading context.

6. *Exempt Transactions and De-Minimis Test of Materiality*.

Certain transactions viewed as not negatively impacting investor confidence in the market and the public interest are exempt from the insider trading regulations under Article 166 of the FIEA. These include, among others, purchases pursuant to rights offerings, exercise of warrants and exercise of existing option contracts, certain treasury stock awards to employees of the issuer, exercise of appraisal rights in business combinations, defensive purchases of shares in a tender offer context, certain ''stabilization transactions'' in the context of a public offering, and certain off-exchange transactions where material information is known to both parties.[16]

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[6] See http://www.fsa.go.jp/common/law/fie01.pdf at 471.

[7] See http://www.fsa.go.jp/common/law/fie01.pdf at 474.

[8] Article 27~27-4 of the Enforcement Order of the FIEA (''FIEAEO'').

[9] Relevant exchanges would include the Tokyo Stock Exchange, Osaka Securities Exchange and various regional exchanges.

[10] See http://www.fsa.go.jp/common/law/fie01.pdf at 470.

[11] See http://www.fsa.go.jp/common/law/fie01.pdf at 470.

[12] Article 166(2)(i) of the FIEA, Article 28 of the FIEAEO.

[13] The dishonoring of a note (typically by a bank) at a note clearinghouse is typically an immediate precursor to an insolvency filing in Japan.

[14] Article 166(2)(ii) of the FIEA, Article 28-2 of the FIEAEO.

[15] Article 166(2)(iv) and (viii) of the FIEA. See http://www.fsa.go.jp/common/law/fie01.pdf at 473 and 474.

[16] Article 166(6) of the FIEA. See http://www.fsa.go.jp/common/law/fie01.pdf at 475.

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Regulations under Article 166 of the FIEA provide some relief from the scope of material non-public information by providing certain ''de-minimis'' standards for material non-public information in specific situations. A discussion of these exemptions is beyond the scope of the discussion here. However, in general, the relevant exemptions apply only to specific situations where objective metrics can be applied (e.g., certain business combinations where net asset value will increase (or decrease) by less than 30 percent and net revenue by less than 10 percent).

7. *When Does Information Become 'Publicized'?*

One of the more difficult issues in providing practical advice with respect to trading activities in the Japanese market is determining when an item of information that might be considered ''material non-public information'' has become sufficiently ''publicized'' that the investor's trading desk can trade in the security.

When trading desk compliance professionals at institutional investors determine that a trader (or analyst in an investment platform that does not maintain ''firewalls'') has received material non-public information, immediate action will typically be taken to place the relevant security on the firm's ''restricted list'' so that further portfolio purchases and sales in the security will be suspended in order to avoid the possibility of trading on material non-public information. Such action can expose these investors to substantial risk if their portfolio positions are significantly long (or short) at the time the information is received. This results in considerable pressure from risk control managers (as well as traders) to ''disinfect'' the firm as quickly as possible so that trading and risk management procedures can be recommenced.

Unfortunately, obtaining certainty that the firm is no longer ''infected'' with material non-public information is not easy to accomplish under Japanese rules. Relevant regulations[17] provide that, in order for information to become ''publicized'' (with certainty), one of the following conditions must be met. The information must:

(i) have been delivered to a listing exchange (such as the Tokyo Stock Exchange) and the exchange has made such information available for public inspection;

(ii) have been disclosed in a public securities filing such as a securities registration statement; or

(iii) have been disclosed in two national ''newspapers or broadcast mass medias'' followed by a period of 12 hours.

Aside from the archaic nature of these procedures in an era of high frequency/low latency trading models, it should be noted that under a literal interpretation of the regulations only disclosure by the issuer (or a person who was delegated authority by the issuer to disclose such information) can remove the taint of material non-public information. Thus, even if a firm tainted by material non-public information wished to free itself to trade an issuer's securities by disclosing the information publicly (and likely incurring the hostility of the issuer thereby), such disclosure arguably might not be effective in removing the taint of material non-public information.

Although it was hoped that these regulations would be modernized in connection with the revisions to Japan's insider trading rules in June 2013, these rules remain in effect.

8. *Penalties*.

Administrative penalties and criminal penalties may be imposed in insider trading cases. Article 157 of the FIEA provides that administrative fines may be imposed against financial instruments business operators and Article 198-2 of the FIEA[18] provides for the remedy of ''disgorgement'' of any assets earned through insider trading. Article 197-2(xiii) of the FIEA provides for the imposition of criminal penalties against violations of the insider trading laws including a maximum penalty of penal servitude of up to five years and a criminal fine of up to JPY 5 million. Financial penalties for trading on insider information have historically been relatively modest and there have been only a few criminal cases brought.

9. *Recent Cases*.

There have been two recent noteworthy cases that provide some additional guidance on the Japanese regulator's enforcement of Japan's insider trading rules.

a. Insider Trading Sanction Against Nomura Securities

On Aug. 3, 2012, FSA issued a business improvement order[19] to Nomura Securities Co., Ltd.[20] (''Nomura'') based on allegations of insider trading by certain members of its institutional sales staff. According to the report published on the FSA's website, certain staff members involved in the marketing of commission transactions in the stock of certain issuers believed that they could ''tip'' hedge fund (and other) investors simply by not naming the relevant issuer in factual circumstances where the identity of the issuer could easily be guessed. Marketing of commission transactions refers to the marketing of transactions to hedge funds that generate commission income for the sales staff of the securities house on the basis of speculation on a dilutive offering by a Japanese issuer.

Moreover, according to the FSA report, these staff members routinely made active efforts to obtain confidential corporate information related to secondary public offerings of new shares by customers of Nomura raising capital from other Nomura departments in possession of such information (i.e., underwriting staff) and used the information obtained in order to promote trading by such investors (to generate trading commission income). These actions gave rise to the recommendation to FSA for a business improvement order which was accepted by FSA and imposed on Nomura Securities.

b. Sanction against Japan Advisory Related to Insider Trading

Japan Advisory LLC[21] (''JA'') was a registered investment advisory firm in Japan that was sanctioned on Nov. 2, 2012.[22] The FSA's sanction report alleges that JA received insider information concerning the decision by management of a listed company (Elpida Memory, Inc.[23] (''Elpida'')) to conduct a public offering of Elpida

[17] Article 166(4) of the FIEA. See http://www.fsa.go.jp/common/law/fie01.pdf at 474.

[18] See http://www.fsa.go.jp/common/law/fie01.pdf.

[19] See http://www.fsa.go.jp/en/news/2012/20120803-1.html

[20] http://www.nomura.co.jp/

[21] http://www.japanadvisory.com/

[22] http://www.fsa.go.jp/sesc/english/news/reco/20121102-1.htm

[23] http://www.elpida.com/en/index.html

convertible bonds in a transaction to be underwritten by Nomura.

The FSA sanction alleges that JA discovered such ''inside information'' by virtue of the fact that JA analysts noted that Nomura provided JA with research materials regarding the electronics industry in which the information about Elpida was deleted. Because JA was aware that Elpida required additional equity financing regularly, the exclusion of Elpida in the research suggested to JA that Nomura had deleted such information from its regular report because of the anticipated secondary offering. Based on this analysis, JA then allegedly sold Elpida shares ''for its clients.'' Based on a recommendation from the SESC, FSA imposed JPY 120,000 of administrative monetary penalty on JA in April, 2013.[24]

[24] JA also lost its investment advisory registration in a separate sanction based on the conduct of a discretionary investment management business without a registration.

See http://www.fsa.go.jp/sesc/english/news/reco/20120823-2.htm. The discussion herein only relates to the insider trading elements of the regulator's actions against JA.

The JA case is important to compliance professionals because it suggests that the types of information (and the methods by which it can be obtained) that can give rise to insider trading may be very broad in Japan.

The JA case can be viewed as standing for the propositions that: (i) omissions of information (e.g., the identity of a potential secondary issuer) standing alone can constitute insider information; (ii) the intention to provide such information may be imputed from the mere transmission of the information to the recipient with the knowledge that the recipient could act on it (i.e., specific intent for the information to be used may not be required).

9. *Future Enforcement Activity*.

It appears likely that the FSA and SESC will continue to aggressively pursue insider trading activity going forward as a key element of their ''better regulation'' initiative.

Over the past decade, the SESC has developed significantly its market monitoring and trading expertise, and upgraded its technology and personnel resources to combat insider trading have improved greatly. As a result, it can be anticipated that active enforcement of Japan's insider trading regulations will continue for the foreseeable future.

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