Recent Developments in Disclosure Requirements

The *Financial Instruments and Exchange Law* has made some significant changes to the way that companies disclose information to the regulatory body. Masatsura Kadota explains the details and ramifications of the new rules as they apply to both domestic and foreign companies operating in Japan.

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The *Financial Instruments and Exchange Law* (FIEL), promulgated in June 2006, makes various amendments to the current regulations under the *Securities and Exchange Law* (SEL). One of the major areas affected by such amendments is the disclosure rules under the SEL. Notably, these amendments include revisions to the disclosure rules applicable to securities offerings, the introduction of mandatory certifications on statements in annual and other reports, a mandatory requirement to file quarterly reports and the introduction of a requirement for managerial assessment of internal controls.

Recent legislative history

The amendments to disclosure requirements made by the FIEL address the need to cope with cases involving misconduct and other inappropriate measures caused by inadequate disclosure. The requirements also address the need for enhanced investor protection and flexibility in regulations to reflect the diversification of financial instruments. In recent years, these same needs have motivated various amendments to the SEL and the regulations enacted within it.

Recent amendments to the SEL in 2003 have:

(i) enhanced the scope of corporate disclosure requirements with respect to corporate governance, risk factors and management's discussion and analysis on financial conditions and results of operations;

(ii) introduced voluntary certifications of statements in annual and other reports, and

(iii) relaxed the requirements relating to small private placements and made equity related securities eligible for professional private placement limited to qualified institutional investors.

In 2004, additional amendments to the SEL broadened the scope of securities subject to the SEL to include interests in investment business limited partnerships and certain other rights and imposed an administrative surcharge on material misstatements in registration statements for public offerings.

In 2005, further amendments to the SEL required parent companies of listed companies to file reports on its status,[1] imposed an administrative surcharge on material misstatements in annual and other reports and made it permissible for certain foreign issuers to file annual and other reports in English.[2]

Stock exchanges have also introduced and implemented systems designed to enhance the scope of, and to ensure the fairness of, corporate disclosure. For example, since the fiscal year beginning on April 1 2003, the Tokyo Stock Exchange has requested listed companies to disclose certain quarterly information and gradually enhanced the scope of such quarterly information. In addition, since January 2005, it has required listed companies to submit declarations on timely and proper disclosure as well as certifications on the adequacy of annual reports, both of which are made public.

The FIEL further enhances the scope of, and introduces flexibility in, disclosure requirements in line with the developments described above.

Revisions to disclosure rules applicable to securities offerings

Expansion of scope of securities subject to disclosure requirements and increase in flexibility

The FIEL expands the scope of regulated securities to include interests in trusts and interests in any collective investment schemes. As such, these are deemed to be securities subject to the regulations under the FIEL. However, they are not subject to the disclosure requirements under the FIEL in principle, reflecting law liquidity of these securities in general. Interests in collective investment schemes that primarily invest in securities and certain

other types are subject to the disclosure requirements under the FIEL.

Considering the method of establishing collective investment schemes, the criteria for conducting a primary or secondary public offering of such interests is modified (in contrast to an offering of shares, bonds or other securities) to the effect that an offering of interests in securities investment schemes constitutes a public offering when a substantially large number of investors will acquire such interests as a consequence of the offering. Under the SEL, any solicitation to a large number of potential investors (50 or more) and any solicitation not constituting a private placement are subject to the requirements applicable to a public offering. In contrast, any solicitation of offers to buy interests in securities investment schemes will constitute a public offering only when the number of purchasers as a result of such solicitation will be substantially large (expected to be 500 or more).

Further, to require appropriate disclosures taking into consideration the characteristics of certain securities, the FIEL explicitly classifies securities into corporate finance-type securities and asset finance-type securities, and requires disclosure for asset finance-type securities with respect to asset management and details regarding the relevant assets. Similar disclosure is required under ministerial ordinances currently effective under the SEL, but such disclosure is expected to be reformed to disclose more detailed information reflecting the characteristics of the relevant securities. Further, upon approval of the Prime Minister, issuers of asset finance-type securities may be allowed to substitute a portion of their annual and other reports with some of other reports describing such substituted portion filed under the FIEL or other laws or rules of the stock exchanges regulating businesses of such issuers.

Disclosure requirements relating to public offerings in connection with corporate reorganizations

Under the SEL, issuances or delivery of shares or other securities in connection with mergers, corporate splits, share exchanges and other corporate reorganizations are not treated as "offerings" of securities, based on the theory that no solicitation is involved in the acquisition of such securities. The FIEL, on the other hand, will require disclosures equivalent to a public offering requiring to file a securities registration statement upon the issuance or delivery of shares or other securities in connection with certain corporate reorganizations. Specifically, such disclosures are required where the number of shareholders of the target company in the corporate reorganization exceeds a threshold set by cabinet order, and where (i) the target company is already subject to disclosure requirements with regard to its shares or certain other equity securities under the FIEL but (ii) the issuer of securities to be issued or delivered in the corporate reorganization is not subject to disclosure requirements under the FIEL with regard to such securities. Filing of securities registration statements in connection with corporate reorganizations will trigger continuous disclosure requirements for the issuer of securities in the corporate reorganization. Accordingly, holders of shares of a target company which is subject to disclosure requirements will continue to receive equivalent information pursuant to the disclosure requirements under the FIEL with respect to the securities to be issued or delivered in connection with the corporate reorganization. Therefore, when securities are to be used as consideration in connection with a corporate reorganization and the target company is subject to continuous disclosure requirements, the issuer must file a securities registration statement with respect to the securities to be issued or delivered before informational documents are made available and before certain other actions are taken relating to the corporate reorganization, unless disclosure under the FIEL has already been made with respect to the securities used as consideration in the corporate reorganization.

On the other hand, securities registration statements will not be required in connection with merger transactions between listed companies involving the issuance or delivery of securities issued by any such listed companies as is the case under the current legislation. Further, consistent with general corporate disclosure requirements, the above requirements are applicable regardless of whether the issuer of shares or other securities to be issued or delivered in connection with a corporate reorganization is a Japanese company or a foreign company.

Revisions to exemptions applicable to continuous disclosure requirements

Under the SEL, issuers may obtain an exemption from continuous disclosure requirements after the filing of a securities registration statement for a public offering of securities only when the number of holders of securities offered becomes less than 25, and upon the approval of the Prime Minister. However, as it is not common for an issuer to redeem its shares, it is difficult to meet the requirements for this exemption even where the liquidity of the shares is low and continuous disclosure would not otherwise be needed. Accordingly, the FIEL amends the exemption requirements to allow an exemption from continuous disclosure requirements triggered by a public offering of shares where such shares are not listed on any stock exchange and where the number of holders as of the end of the fiscal year is less than a threshold set by cabinet order (expected to be 300) for at least five consecutive fiscal years.

Mandatory certifications on statements in annual reports

The requirement for voluntary certifications on statements in

annual and other reports was introduced by an amendment to the SEL in 2003. Stock exchanges have also requested listed companies to submit similar certifications, but submission of a certification in response to such request was not a legal requirement.

The FIEL requires listed companies, on a mandatory basis, to file certifications confirming the adequacy of statements in annual reports and quarterly reports, and the failure to submit any certification will subject the issuer to criminal sanctions. Such certification must be filed concurrently with the relevant report. A misstatement in a certification will not subject the issuer to criminal sanctions because such misstatement overlaps with a misstatement in the accompanying report.

The new certification requirement is intended to improve the awareness of the issuer's management with respect to full and adequate disclosure and to practically limit the ability of the representative signing the certification to defend a misstatement in an annual or other report by pleading a lack of knowledge of such misstatement or a similar defense.

Specific details with respect to the certification requirements will be set forth by a cabinet ordinance. It is expected that the certification will be required to be signed by a representative and the chief financial officer, if any, of the company filing annual and other reports. Confirmation of the adequacy of statements in annual and other reports will motivate the establishment of effective internal controls governing the proper preparation of such reports.

Legislation of quarterly reports

As mentioned above, stock exchanges, including the Tokyo Stock Exchange, have requested that listed companies disclose certain quarterly information, but this is not a legal requirement. Moreover, under the quarterly disclosure systems established by stock exchanges, the standards for the preparation of quarterly financial statements have not been sufficiently unified and such quarterly financial statements are not required to be reviewed by independent auditors.

The FIEL introduces a mandatory requirement for listed companies to file quarterly reports. Foreign companies whose securities are listed on Japanese stock exchanges are also subject to the new requirement to file quarterly reports. Non-listed companies may voluntarily file quarterly reports. Further, as listed companies are required to file quarterly reports, they are not required to file interim (semi-annual) reports as such reports are replaced with the quarterly reports for the second quarter of the fiscal year.

In addition, the FIEL requires the quarterly financial statements included in quarterly reports to be audited by independent auditors. The standards and procedures for the audit of quarterly financial statements will be set forth and unified by a cabinet ordinance.

Material misstatements in quarterly reports will be subject to criminal sanctions and administrative surcharges as well as indemnification responsibilities to investors, consistent with those currently applicable to semi-annual reports under the SEL.

The FIEL requires quarterly reports to be filed within a period set by cabinet order, which will be no later than 45 days after the end of each quarterly period. For companies operating certain businesses subject to capital adequacy requirements such as banks and insurance companies, the deadline for filing certain quarterly reports (for the second quarter of the fiscal year) will be extended by cabinet order so that such quarterly reports will not need to be filed until up to 60 days after the end of the relevant quarterly period. This is because certain additional financial information is required for such businesses in their quarterly reports.

In any event, listed companies should establish, prior to the implementation of this requirement, sufficient framework and systems to allow for the timely filing of quarterly reports after having the relevant quarterly financial statements audited by independent auditors.

Introduction of managerial assessment of internal controls

Even prior to the promulgation of the FIEL, various measures have been taken to improve companies' internal controls, including (i) measures in the *Company Law* (which became effective in May 2006), requiring companies to establish internal control systems to ensure proper business operations and (ii) rules of stock exchanges, requiring listed companies to submit reports on corporate governance by the end of May 2006.

The FIEL introduces a requirement for listed companies to file a managerial report on internal controls each fiscal year together with the annual report. The managerial report must evaluate the effectiveness of internal control systems required to ensure the adequacy of the financial information prepared and filed by the listed company on a consolidated and a non-consolidated basis, as set forth in a cabinet ordinance. Managerial reports on internal controls must be audited by independent auditors in principle, and any failure to submit, or any material misstatements contained in, the reports are subject to criminal sanctions.

These new requirements are meant to be the Japanese equivalent of similar requirements in the United States under the Sarbanes-Oxley Act of 2002. However, the standards for evaluations by

management and audits on internal controls by independent auditors currently under discussion for the Japanese system are not expected to be as strict as the standards required under the U.S. system, recognizing the concern that the U.S. requirements impose very onerous burdens on issuers.

The rules applicable to internal controls under the *Company Law* are to ensure proper business operation. On the other hand, the rules governing internal controls on financial reporting under the FIEL are focused on financial reporting, and such rules are stricter because any misstatement in the report is subject to criminal sanctions and also they require an audit by independent auditors.

Accordingly, under the FIEL rules, a certain level of internal control on financial reporting is practically required for purposes of this audit. Although the valuation standards and auditing standards for internal controls on financial reporting have not been made clear at this stage, listed companies will need to be sufficiently prepared prior to the implementation of this requirement, considering the requirement that the report be audited.

Timing of implementation

The revisions to disclosure rules applicable to securities offerings will take effect within 18 months after the promulgation of the FIEL on June 14 2006, as specifically set forth by cabinet order. The mandatory certifications on statements in annual and other reports, the requirement to file quarterly reports and the requirement for a managerial assessment of internal controls will be required from the first fiscal year beginning on or after April 1 2008.

Endnotes

1 This amendment is applicable from the first fiscal year of the parent company beginning after April 1 2006.

2 The amendment to permit foreign issueses to file reports in English has been applicable to the reports of any Foreign Exchange Trade Fund filed from and after December 1, 2005, and will be applicable to the reports of other foreign

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issuers filed from a date, on or prior to March 31, 2009, to be designated in an enforcement order.

About the author

Masatsura Kadota is a partner at Nagashima Ohno & Tsunematsu. His practice focuses on capital markets, like global offering of securities by Japanese corporations or public offering or private placement in Japan by foreign issuers, and other corporate or financial laws and regulations. He graduated in1996 with an LL.B from the University of Tokyo, Department of Law, and in 2003 graduated with an LL.M from Duke University School of Law. He was admitted to practice in Japan in 1998 and in the state of New York in 2004.