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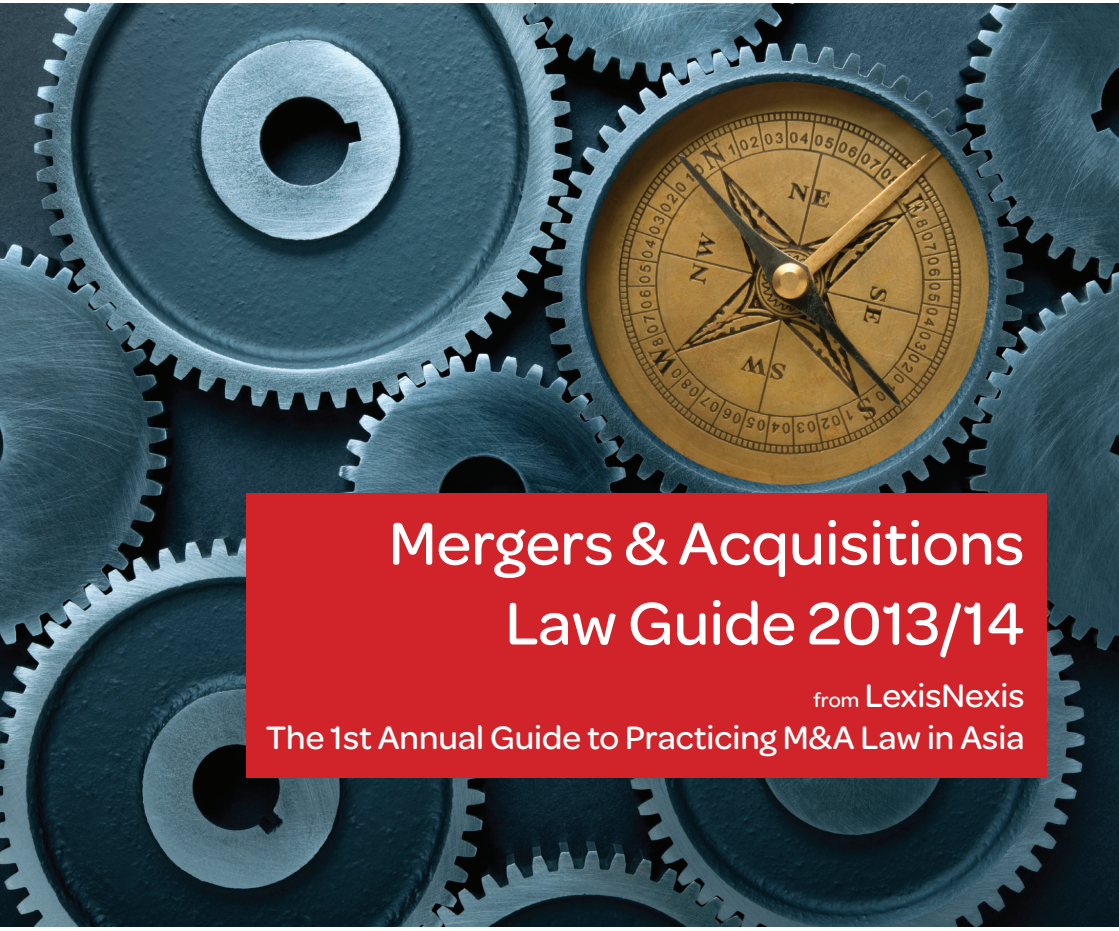

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Nagashima Ohno & Tsunematsu

Specialist Article:

Recent Developments in Japanese Insider Trading Regulations in the Context of M&A

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Recent Developments in Japanese Insider Trading Regulations in the Context of M&A

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Introduction

Recent years have witnessed significant developments in Japanese insider trading regulations. In terms of legislative developments, certain amendments to the statutory ban on certain insider trading, as codified in the Financial Instruments and Exchange Law of Japan (FIEL), were approved by the Diet in September 2012 and June 2013. The 2012 amendment, which will take effect no later than September 2013, aims to modify the applicability of the ban in the context of mergers and acquisitions. The latest amendment from 2013 is expected to be implemented in 2014 and will newly penalize certain insiders for giving tips on non-public information.

The Securities and Exchange Surveillance Commission of Japan (SESC) has been actively enforcing the insider trading regulations. Responsible for market surveillance and investigation of insider trading activity, the SESC makes recommendations on administrative, monetary penalties (*kachoukin*) to its supervising agency, the Financial Services Agency (FSA), and files criminal charges (*kokuhatsu*) for public prosecutors to prosecute. In 2012, for instance, the SESC demonstrated its firm stance to crack down on insider trading by institutional investors in connection with public offerings, recommending administrative sanctions in connection with as many as six incidents in that year alone.

The illegal insider trading regime is one of the key areas of law of which all M&A practitioners should be mindful. This article aims to provide a summary of recent developments in Japanese insider trading regulations, with a focus on the context of mergers and acquisitions in Japan.

This article is organised as follows: Section I provides an overview of the Japanese insider trading regulatory regime. Section II examines the proposed 2013 amendment to the regulatory regime to sanction 'tippers' and the background for the latest move. Section III discusses some of the key insider trading issues under the 2012 amendment and their implications on transaction structures. Lastly, Section IV summarises the trend of enforcement by the SESC.

I. Overview of Japanese Insider Trading Regulations

Elements of Illegal Insider Trading

The FIEL sets forth two sets of provisions prohibiting insider trading, namely arts 166 and 167. Article 166 concerns trading by insiders of equity securities of a publicly-traded company generally, while art 167 applies only in the context of tender offers to purchase equity securities of a listed issuer and other acquisitions of five per cent or more of the voting interest in a listed issuer. Unless otherwise noted herein, for the purposes of art 167, acquisitions of five per cent or more of the

voting interest of a listed company by a third party is regulated in a similar manner as a tender offer for shares of such company by a third party.

Key elements of the insider trading prohibited under arts 166 and 167 are:

- Sales or purchase of any shares or other equity securities of a publicly-traded issuer[1]
- By certain insiders (see sub-section 'Insider Requirement' below)
- While in possession of certain material facts about the issuer or a tender offer for shares of the issuer, as applicable (see sub-section 'Material Facts Requirement' below)
- Before such facts are duly made public (see sub-section 'Made Public Requirement' below)

Note that, unlike in some other jurisdictions, it is not a pre-requisite that the relevant insider executes deals 'using' non-public material facts in order to be subject to prohibitions on insider trading in Japan.

Insider Requirement

The Japanese insider trading regulatory regime penalizes two groups of insiders – 'Related-Party Insiders' and 'Tippees'. Related-Party Insiders are further divided into those related to a listed issuer under art 166 and those related to a tender offeror under art 167.

Related-Party Insiders are generally defined in the FIEL as noted below (with No. 5 below to be effective upon implementation of the 2013 amendment). Note that such Related-Party Insiders will be subject to the prohibition on insider trading only if they learn relevant inside information in the manner set forth in the respective parentheses below:

1. Officers, agents and employees of the issuer or the tender offeror (in connection with the performance of their duties);
2. Shareholders holding three per cent or more of the total voting rights of the issuer or the tender offeror (in connection with the exercise of its statutory right of inspection of accounting books);
3. Parties having statutory power over the issuer or the tender offeror (in connection with the exercise of such power);
4. Parties that have executed or are negotiating a contract, whether written or oral, with the issuer or the tender offeror (in connection with the execution, negotiation or performance of such contract);
5. The target company of the tender offer (upon notice by the tender offeror); and
6. Officers, agents and employees of the parties referred to in No. 2 or 5 mentioned above (in connection with the performance of their duties).

Tippees are persons who receive a tip of inside information from a Related-Party Insider and are also subject to the insider trading prohibition. Conversely, those who learn of inside information from Tippees (secondary tippees, so to speak) are **not** subject to the insider trading prohibition. In practice, however, the distinction between primary Tippees and secondary tippees is not always easily discernible.

Material Facts Requirement under Article 166

For the general insider trading prohibition under art 166, the FIEL provides for four categories of 'material facts', namely:

1. Facts based on a corporate decision of the issuer or any of its subsidiaries;
2. Facts based on the occurrence of certain events or circumstances of the issuer or any

of its subsidiaries;

3. Facts based on financial forecasts of the issuer or any of its subsidiaries; and

4. Other material facts regarding the operation, business or assets of the issuer or any of its subsidiaries that would have a significant impact on the investment decision of investors (basket clause).

The FIEL and its pertinent rules set forth a long catalog of specific corporate actions, events and circumstances that would fall under categories No. 1 through No. 3 mentioned above, as well as applicable *de minimis* criteria based on numerical or qualitative thresholds. Category No. 4 on the other hand, is a so-called basket or 'catch-all' clause, which is discussed in Section IV below.

Importantly, a 'corporate decision' of a listed company is often found by courts to have been made at a point much earlier than the time of the official decision making at the company. For one, 'corporate decisions' can be made by not only the board of directors of a company, but also by any executive organ that could make a substantially equivalent decision, such as a committee of selected executive board members or, in some cases, the chairman or the president. Furthermore, a 'corporate decision' is **not** limited to an official decision to implement a designated transaction, but may also include an informal decision to 'work toward' implementing such action. The Supreme Court has ruled that, in order for a corporate decision to be found to have been made, the relevant executive organ must have made such decision 'intending' to implement an action, but it need not be the case that such action was certain to be implemented at the time of the decision.

Material Facts Requirement under Article 167

The scope of inside information under art 167 is somewhat limited as compared to that under art 166. A corporate decision of: (i) a third-party offeror to launch a tender offer for equity securities of a public corporation; (ii) a third party to purchase such equity securities representing five per cent or more of the voting interest in the issuer; or (iii) the issuer itself to launch a self-tender offer for its own shares, or a corporate decision to discontinue said transaction, constitute inside information under art 167.

Made Public Requirement

Any information that has been duly 'made public' does not constitute inside information for purposes of arts 166 and 167. The FIEL contemplates three measures that constitute publication:

1. Disclosure to at least two major news outlets in Japan followed by a 12-hour blackout period;

2. Disclosure on the electronic system of the relevant securities exchange;[2] and

3. Filing with the competent Financial Bureaus of certain statutory disclosure documents.

Note that in each case for information to have been deemed 'made public', the disclosure must be made by the listed issuer or the relevant subsidiary in the case of art 166, and by the tender offeror in the case of art 167. A leak of information to news media or a public announcement by a third party, technically, does not suffice to satisfy the made public requirement.

Exemptions

The FIEL provides for a number of exemptions in respect of insider trading regulations. Exemptions most relevant in the context of M&A transactions are: (i) trading pursuant to pre-insider contracts/plans; and (ii) off-market trading between insiders.

Under exemption (i) noted above, if a person received inside information only after: (a) entering into an agreement to acquire or dispose of equity securities of a listed company; or (b) announcing a

plan of a tender offer, the person will generally not have violated the prohibition on insider trading even if the person completes the transaction pursuant to the agreement or the tender offer plan and actually acquires (or, in the case of (a), dispose of) the securities. In the context of M&A activity, however, this exemption as currently codified is too rigid. In the case of (b), for instance, if such person amended certain terms of such previously announced plan of the tender offer after receiving inside information, the exemption is not available and the tender offeror may risk violating the prohibition on insider trading. A more blanket exemption is expected to be introduced by the 2013 amendment.

As for exemption (ii), off-market trading of equity securities of a target company between persons with knowledge of a yet-to-be-announced tender offer to purchase the target company's shares, whether Related-Party Insiders, Tippees or otherwise, is generally exempt from the insider trading prohibition under art 167. With respect to the art 166 general prohibition, on the other hand, an equivalent exemption applies only if such off-market trading is made between Related-Party Insiders and/or primary Tippees only. An exception to the foregoing exemptions applies where both parties know that the securities sold or purchased off-market will thereafter be traded in violation of insider trading regulations. The 2013 amendment will broaden the exemption in respect of art 166 to apply to off-market trading between any persons with knowledge of inside information, including secondary tippees, which is expected to ease the conduct of block trading.

Penalties

Violations of arts 166 and 167 are subject to criminal and/or administrative sanctions. Unlike in some jurisdictions, it is not a prerequisite that an insider actually gain any profit or avoid any loss as a result of insider trading to be prosecuted under art 166 or 167.

As for criminal penalties, violation of the insider trading prohibition may be subject to imprisonment for a period of up to five years, or a fine of up to five million yen, or both, as well as confiscation or collection of the monies earned. If an officer or employee of a corporation commits an insider offence with respect to the corporation's operations or property, then the corporation may also be subject to a fine of up to five hundred million yen.

As for administrative sanctions, a monetary penalty (*kachoukin*) may be imposed by the FSA independently of a criminal penalty. Generally, the amount of an administrative monetary penalty is determined based on the amount of economic benefit that the insider gains as a result of the illegal trading. For an insider trading offence committed by an investment manager trading on account of its client, under the 2013 amendment, the amount of administrative monetary penalty will generally be three times the amount of the investment manager's fees for the month during which the offence took place.

II. Proposed 2013 Amendment – Tipping Inside Information Penalized

Background for Regulating Tippers

The latest amendment to the Japanese insider trading regulations passed the Diet in June 2013 and is expected to be implemented in 2014. Of the various issues covered by this amendment, the amendment will introduce a prohibition on passing inside information concerning listed securities to others and make other recommendations regarding the trading of such securities to others under certain circumstances. This amendment is significant in that it introduces new forms of illegal insider trading prohibited under Japanese law.

Underlying the introduction of this amendment was a series of cases where institutional investors were charged with trading on non-public information concerning public offerings by Japanese listed companies. In all six of these cases, the charges

for which were all brought in 2012, the investors had been tipped by sales/research representatives of the lead underwriter in the public offering, who, despite the internal Chinese Wall, had some level of access to, or was able to make inferences based on, the confidential information. The current insider trading regime does not prohibit the act of tipping itself (except as it may constitute aiding and abetting), and none of the personnel who passed on the confidential tips were charged with insider trading.

Prohibited Tipping and Recommendation on Trading

With a view to preventing unjust tipping and subsequent insider trading by tippers, the proposed amendment, in summary, bans:

- Related-Party Insiders (see sub-section 'Insider Requirement' in Section I above), as distinguished from Tippees
- From tipping material facts concerning a publicly-traded issuer or a tender offer, as applicable, or recommending a sale or purchase of securities of the issuer or the target of the tender offer, as applicable (prohibited activity)
- To another person
- With the intention of inducing such person to trade such securities, either to gain profits or avoide losses, before such material facts are made public (the test of intention)

The scope of prohibited activity is fairly broad. In addition to regulating the passing on of inside information, the amendment may also restrict a corporate insider from recommending to another person that he or she deal in securities of a listed company even where the corporate insider does not disclose inside information. Limiting the breadth of prohibited acts under the amendment, the intention test supposedly serves to exonerate from insider trading offence M&A transactions, business negotiations, investor relations initiatives or other legitimate activities that involve exchange of non-public material information on public corporations.

Another mechanism to prevent overbroad deterrence of legitimate activities is the requirement that criminal and administrative sanctions are applicable only if, as a result of the prohibited tipping or recommendation, the recipient of the inside information or the recommendation actually trades the subject securities prior to the disclosure of relevant inside information (actual trading requirement).

As of this writing, commentary by the FSA officials in charge of drafting the amendment has not yet been published, and there is little discussion as to how this new rule, particularly the test of intention, should be interpreted or evidenced.[3] Individuals and corporations that deal with non-public material information on public companies should review their internal insider trading policies as well as non-disclosure agreements and other contracts with external parties to minimise the risk of intentional or inadvertent violations of the new rule.

Other Areas of 2013 Amendment

The 2013 amendment also attempts to address various insider trading issues arising in connection with a tender offer. Under the current regime, conduct or cessation of a tender offer or other acquisition of five per cent or more of the voting interest in a listed company (hereinafter known as 'the target') constitutes inside information under art 167, and must be announced at the initiative of the tender offeror in order for the information to be considered public (see sub-section 'Made Public Requirement' in Section I above). This requirement could serve as a virtual defense measure in the context of potentially competing takeover bids. Suppose, for example, that a potential acquirer, Company A, decided to launch a tender offer against

the target but had not yet publicly announced the planned offer. Company A may disclose its unannounced plan to a third party, Company B, and make Company B a primary Tippee, upon which Company B will be virtually blocked from acquiring shares of the target until Company A announces its plan pursuant to the FIEL.

The 2013 amendment provides for exemptions in such a scenario. First, Company B may purchase the target shares by way of a tender offer prior to Company A's announcement, provided that Company B discloses Company A's plan and certain other information in its tender offer documents. The rationale behind this exemption is that such disclosure will eliminate the information gap between Company B, the insider, and the shareholders of the target. Note that this exemption is not available if Company B is to acquire the target shares other than through a tender offer, for instance, by block trading.

In addition, despite the absence of Company A's announcement of its possible tender offer, Company B may legally acquire the target's shares, by way of a tender offer or otherwise, once six months or more have passed after Company B learned of Company A's proposed tender offer.

III. 2012 Amendment – Insider Trading and Acquisition Structures

The 2012 amendment to the FIEL, which is scheduled to be implemented in September 2013, modifies the scope of acquisition structures that may be subject to Japanese insider trading restrictions. Prior to implementation of this amendment, the transfer or acquisition of publicly-traded shares by way of merger (*gappei*) or de-merger (*bunkatsu*) is not subject to Japanese insider trading restrictions, while such transfer or acquisition by way of transfer of all or part of the business (*jigyou jouto*) is. This disparity results from the Japanese legal concepts that distinguish a merger or de-merger, where the subject assets are transferred as a whole by operation of law, and a transfer of business, which is considered a collection of individual sales and purchases of the subject assets.

The amended insider trading rules treat mergers, de-mergers and business transfer equally as a means to transfer or acquire publicly-traded shares.[4] Where the assets subject to a merger, de-merger or business transfer include shares of a public company and one or more parties to such transaction possess inside information on the issuer, the relevant transfer or acquisition of shares is generally subject to the prohibition on insider trading. An exemption will apply if the book value of such shares comprises less than 20 per cent of the aggregate book value of all the transferred assets.

Issuance or acquisition of newly-issued shares of a public company in, for instance, private investment in public equity (PIPE) transactions, is not subject to Japanese prohibitions on insider trading. In contrast, the prohibition generally applies to the resale or purchase of treasury shares of a public company. As an exception to the foregoing, the 2012 amendment states that use of treasury shares as a result of mergers, de-mergers and other restructuring (*soshiki saihen*) proceedings does not trigger the insider trading restrictions.

IV. Trend of Enforcement of Insider Trading Regulations

Statistical Facts

The SESC has been actively pursuing illegal insider trading in recent years. According to statistics published by the SESC, the number of incidents where the SESC recommended administrative penalties on account of insider trading violations peaked at 38 in fiscal year 2009, with 19 incidents in fiscal year 2012.[5] In terms of criminal sanctions, the SESC filed insider trading criminal charges in seven and two instances in fiscal years 2009 and 2012, respectively.[6]

Tender offers and public offerings comprise the majority of the incidents where insider trading violations were recently found by the SESC. Both types of transactions appear to create a breeding ground for illegal activity as they involve a large number of parties and tend to have a fairly predictable impact on the stock price.

Basket Clauses

The SESC has been enforcing not only administrative penalties but also pursuing criminal insider trading charges utilising the basket clauses of the FIEL (see sub-section 'Material Facts Requirement under Article 166' in Section I above), although the number of such charges is fairly limited.

The scope of the basket clauses is, by nature, not defined. It could cover any corporate actions, events or circumstances that are not specified in the other categories of 'material facts' so long as they would have a significant impact on the investment decision. Furthermore, even if, for example, a certain event is actually specified in one of such other categories yet falls under the applicable *de minimis* criteria, this basket clause may still apply if there exist other elements regarding such event that would have a significant impact on the investment decision. The basket clause, which serves as a catch-all to a thorough catalogue of specific material facts, has sometimes been criticised as overbroad.

Incidents where the courts found an insider offence based on the basket clauses include reports of deaths caused by the side effects of promising new drugs, discovery of errors in the financial results of past years or inappropriate accounting treatment for multiple fiscal years, and the procurement of syndicated loans by a cash-strapped company. To avoid the application of the basket clause, careful analysis is required as to whether ordinary investors would certainly have conducted, or withheld, a sale or purchase of equity securities of a listed company had they had access to the non-public information regarding the company in question.[7]

Conclusion

The FSA has been emphasising the importance of various market participants, including the financial industry, stock exchanges and listed companies, to establish a system to prevent insider trading. As of this writing, pertinent rules of the 2013 amendment have not yet been published, and the extent of the implications of the amendment is not fully comprehensible. It is, therefore, critical that all public companies and other firms interested in the acquisition of listed firms introduce and periodically review their insider trading policies and practices in order to reflect the then best practice towards minimising the risk of insider trading.

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1 Those equity securities issued by a Japanese listed company but not publicly-traded (such as class shares or bonds) could also trigger the insider trading prohibition. In addition, art 166 regulates both the sales **and** purchase of shares of a listed issuer while having inside information regarding the issuer, while art 167 regulates the purchase or sale of such shares – that is, purchase of such shares knowing the launch of a tender offer for such shares and sale of such shares knowing the cancellation of a tender offer.

2 With respect to inside information concerning a tender offer by a third party under art 167, this method No. 2 is not available at present. The 2012 amendment to the FIEL would permit, as method of publication of inside information, disclosure of inside information on the electronic system of the relevant securities exchange (i) by a tender offeror whose shares are listed on such exchange, or (ii) by the target or its parent company whose shares are listed on such exchange at the request of a non-listed tender offeror.

3 The proposed 2013 amendment to the FIEL was prepared by the FSA taking into account a report published by the insider trading regulation working group established under the Financial System Council, an advisory board to the FSA. The report, titled *Establishment of Systems Regulating Insider Trading in Light of the Recent Insider Violations and Financial and Corporate Practice*, was published in

December 2012 and is available at: http://www.fsa.go.jp/singi/singi_kinyu/tosin/20121225-1/01.pdf.

4 Incorporation-type de-mergers (*shinsetsu bunkatsu*) are exempt from the insider trading restriction, except where two or more corporations conduct incorporation-type de-mergers jointly (*kyoudou shinsetsu bunkatsu*).

5 *Status of Recommendations Made* (as of the end of April 2013), published by the SESC; available at: http://www.fsa.go.jp/sesc/actions/kan_joukyou.htm.

6 *Status of Criminal Complaints Filed* (as of the end of April 2013), published by the SESC; available at: http://www.fsa.go.jp/sesc/actions/koku_joukyou.htm.

7 Yūsuke Yokobatake, *Chikujo kaisetsu: Insaidā torihiki kisei to bassoku [Insider Trading Regulations and Penalties]* (Shoji Houmu Kenkyukai, 1989).

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