

Amendment to Short Selling Regulations in Japan

On July 20, 2011, we issued a newsletter, which outlined the proposed Amendment to the relevant cabinet order and cabinet office ordinance under the Financial Instruments and Exchange Act (the “FIEA”)¹ regarding new regulations on short selling (the “Proposed New Rules”)². The Proposed New Rules were subject to a public comment period that expired on July 25, 2011. On August 26, the Financial Services Agency of Japan (the “FSA”) published an outline of the public comments received, the FSA’s thoughts on them, and a defined Amendment (the “Defined New Rules”) reflecting the public comments. The Defined New Rules were modified slightly from the Proposed New Rules. This newsletter outlines the Defined New Rules including the modification from the Proposed New Rules, as well as the important points raised in the public comments and the FSA’s thoughts on them.

1. Background

In short selling in connection with a public offering of securities, there is a risk that someone who engages in short selling after the announcement of a public offering of securities, but before the offering price is determined and makes the offering price lower, will acquire such securities, and make settlement of the short sale using the securities acquired in the public offering. This transaction creates an imbalance in demand and supply and prevents fair pricing of securities. To address this risk, the FSA decided to create additional regulations on short selling. The Defined New Rules appear to be modeled on Rule 105 of Regulation M under the U.S. Securities Exchange Act of 1934.

2. New regulations

(A) Unlawful Activity

Under the Defined New Rules, in connection with the public offering of securities, any person who undertakes a short sale, or asks a broker (including a broker’s broker) to intermediate a short sale of securities on the relevant securities exchange (i.e., the Financial Instruments Exchange Market) within a certain specified period (the “prohibited period”) is prohibited, subject to certain exceptions, from making settlement of the borrowed securities for such short selling (including securities purchased under repurchase transactions) using the securities acquired by such person through the public offering.

In connection with the above, the FSA clarified that it may also be prohibited under the Defined New Rules for a group of investors acting in concert or together from engaging in

¹ The Cabinet Order for the Financial Instruments and Exchange Act (Cabinet Order No. 321 of 1965) and the Cabinet Office Ordinance for the regulation of securities transactions (Cabinet Office Ordinance No. 59 of 2007)

² http://www.amt-law.com/en/pdf/bulletins2_pdf/110720.pdf

a series of activities that would effectively result in the settlement of securities borrowed for short selling within a prohibited period, if the securities were acquired in a public offering. In addition, the FSA has advised that this type of scenario possibly violates the prohibition of market manipulation activities (Article 159 of the FIEA) (response to public comments No.3 and No.4).

Where short selling and the acquisition of securities through a public offering are effected under different investment decisions and different accounts (e.g., where an investment management company invests under a number of separate agreements with clients), the new regulation above does not apply unless the borrowed securities for such short selling are settled using the securities acquired through the public offering (response to public comments No.7, No.8 and No.9).

The “prohibited period” above means the period commencing on the day after the relevant Securities Registration Statement or Extraordinary Report, as the case may be, prepared in connection with the announcement of the public offering, is filed and made available for public inspection and ending on the date on which an amendment to such Securities Registration Statement or Extraordinary Report is filed and made available for public inspection in connection with the pricing of the offered securities.

The Defined New Rules also apply to short selling in any OTC securities market established by an authorized financial instruments traders association. However, currently there is no such OTC securities market.

(B) Exceptions

There are exceptions to the above prohibition, which are as follows:

1. Dealing in listed securities futures (e.g., Japanese Government Bond (“JGB”) futures listed on the Tokyo Stock Exchange)
- 2 Short selling of certain specified securities which include the following:

JGBs, municipal bonds, special corporate bonds issued by government affiliated corporations, corporate bonds (other than convertible bonds, bonds with warrants and exchangeable bonds), securities similar to those issued by foreign nations/municipal governments or foreign corporations, domestic and foreign Exchange Traded Funds (“ETFs”), bonds issued by domestic and foreign investment corporations, domestic and foreign ETFs in the form of trust certificates, beneficiary certificates of securities trusts, the entrusted assets of which are foreign ETFs, bonds issued by foreign investment corporations, or foreign bonds (government, municipal and corporate bonds) and trust-type foreign ETFs, or depositary receipts, the underlying securities of which are foreign ETFs, bonds issued by foreign investment corporations, or foreign bonds (government, municipal and corporate bonds) and trust-type foreign ETFs.

3. Short selling through after-hours trading on a securities exchange (i.e., ToSTNeT,

J-NET, N-NET).

(C) The duty of a securities company

A securities company in Japan registered pursuant to the FIEA is required, when it offers its clients any securities (which are listed securities and are subject to the Defined New Rules) in connection with a public offering of such securities (where a public offering is made before determination of the pricing of the offered securities) to inform its clients, “in advance”, and in writing or by appropriate information-communication technology (i.e., e-mail, on the Internet), to the effect that: (i) if the client has undertaken a short sale, or has asked a broker (including a broker’s broker) to intermediate a short sale of securities on a securities exchange during the “prohibited period”, such client is prohibited from making settlement of the borrowed securities for such short selling using the securities acquired by such person through the public offering; and (ii) if the client is acquiring the securities in the public offering for the purpose of settlement of the borrowed securities for a short sale (including securities purchased under repurchase transactions), the client cannot acquire such securities.

“In advance” as used above means that clients are to be informed prior to any solicitation to acquire securities (response to public comments No.19, No.20 and No.21). A securities company should inform its clients of the above matters in relation to each public offering (response to public comments No.22 and No.23).

3. Modification from the Proposed New Rules

With regard to the duties of a securities company, the Defined New Rules add that a securities company does not have a duty to inform its clients where there is no “prohibited period” in connection with a public offering of securities. In situations where a public offering is made with respect to previously issued securities which have “already been disclosed” (as defined in the FIEA) or where a public offering is made under a “Shelf Registration”, a securities notification or a shelf registration supplement, as the case may be, is required to be filed, but a Securities Registration Statement or an Extraordinary Report does not need to be filed. Accordingly, in these situations, where there is no “prohibited period” in connection with a public offering of securities, the Defined New Rules described above are not applicable. The modification from the Proposed New Rules clarifies this point.

3. Schedule for Implementation

The Defined New Rules will be implemented under the FIEA and will become effective on December 1, 2011.

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