

Amendments to the short selling regulations

As of November 5, 2013, the amendments (the “Amendments”) to the Order for the Enforcement of the Financial Instruments and Exchange Act (the “FIEA”) and the relevant Cabinet Office Ordinance¹ in relation to the short selling regulations have become effective². This newsletter briefly describes the changes to the short selling regulations.

1. Outline of Amendments

The major amendments are as follows:

- (A) Easing of price regulations (from “uptick rule” to “circuit breaker” model)
- (B) Change in reporting and disclosing system
- (C) Permanent ban of Naked Short Selling
- (D) Adding regulations which cover transactions conducted using the Proprietary Trading System (the “PTS”)

A detailed explanation of each of the above is provided below.

2. Easing of Price Regulations

(a) Previous Regulation

Before the Amendment, in the case of short selling:

- If the last two announced prices for the security showed an upward trend, then the investor could sell the security at the last announced price or above (but the security could not be sold at a price lower than the most recently announced price)
- Conversely, if the price of the security was on a downward trend based on the two most recently announced prices, an investor could not sell at the security at a price equal to or lower than the last announced price (i.e., the security could only be sold at a price above the most recently announced price).

The above rule (the “Uptick Rule”) was applied to all short selling transactions.

¹ The Cabinet Office Ordinance on Restrictions on Securities Transactions, etc. (the “Ordinance”)

² The new regulations pursuant to the Amendments apply to any short sale conducted on or after November 5, 2013 and do not apply to any short sale conducted prior to such date.

(b) New Regulation

Following the Amendments, the Uptick Rule will only be applied in the two cases below:

- (i) at any time during the period from commencement of trade to the short sale of the relevant security, if any trading price for the security is equal to or lower than 90% of the Marker Price³ of previous trading day for that security announced by the relevant stock exchange; or
- (ii) on the Main Market⁴ for the relevant security, on the trading day before the day of the short sale for the security, if any trading price for the security is equal to or lower than 90% of the Marker Price of previous trading day for that security announced by the Main Stock Exchange⁵.

Although the new regulation itself (which uses the “circuit breaker” method or “trigger” method) is very complicated, it can be summarized as follows – if the price of a certain security has declined by 10% or more compared to the Market Price of previous trading day on the Main Market, the price regulations will be applied from the time of decline until the close of trading on the following business day.

3. Change in Reporting and Disclosure System**(1) Change in Reporting and Disclosure Requirements**

While the obligation to report information regarding short selling was temporarily imposed in 2008 and extended until present, this obligation has now become permanent following the Amendments⁶. However, the requirements to trigger

³ “Marker Price” means the price which is determined by the stock exchange for the security pursuant to its rules based on the security’s closing price and indication price at the end of trading on the relevant day.

⁴ “Main Market” means, for any security, the market with the highest trading volume (through trading sessions provided for pursuant to the rules of stock exchanges) for that security in the most recent six months, as calculated at the end of the month before the relevant trade occurs. If such Main Market does not exist (such as in the case of an IPO), the Main Market will be the market with the highest trading volume (through trading sessions provided for pursuant to the rules of stock exchanges) for other securities in the most recent six months, as calculated at the end of the month before the relevant trade occurs. The response to public comments issued by the Financial Services Agency of Japan (“FSA”) indicated that the FSA expects that relevant stock exchanges will take the necessary measures to identify and publicly announce the Main Markets for particular securities.

⁵ “Main Stock Exchange” is the stock exchange which operates or manages the Main Market for any given security.

⁶ It should be noted that this reporting and disclosure obligation will be imposed only in relation to the short sale of securities listed on any stock exchange or traded on any authorized OTC securities market (although currently there are no such OTC securities markets). This means that short sales in relation to ADRs (American Depositary Receipts) or other foreign depositary receipts (which are not currently

these obligations have been relaxed⁷. The new criteria are, for any given change:

- (i) if, following the short selling, the Ratio of Short Position⁸ becomes 0.2% or more **and** the Number of Short Position Trading Units⁹ becomes more than fifty (50);
- (ii) if the Ratio of Short Position remains 0.2% or more **and** the Number of Short Position Trading Units remains more than fifty (50), any change in the Ratio of Short Position of 0.1% or more from that reported pursuant to (i)¹⁰; **or**
- (iii) if the Ratio of Short Position changed to less than 0.2% **or** the Number of Short Position Trading Units after the change changed to fifty (50) or less.

In addition, the disclosure criteria have also been amended. Before the Amendments, the information regarding short selling was required to be disclosed (by the stock exchanges) whenever the reporting obligation arose. However, under the new criteria, the information regarding short selling will be required to be disclosed only when:

- (i) the Ratio of Short Position becomes 0.5% or more; **or**
- (ii) the Ratio of Short Position has moved from 0.5% or more to less than 0.5%, **and** the Number of Short Position Trading Units is fifty (50) or less.

(2) Change in Reporting and Disclosure Process

It should be noted that following the Amendments, the disclosure obligations are imposed only on the Main Stock Exchange. Also, not every trader will necessarily be required to report information regarding short selling directly to the Main Stock Exchange. The Exhibit on the last page shows the expected major flow of the

listed on any stock exchange in Japan) are not subject to this obligation.

⁷ According to responses to public comments issued by the FSA, it will be permissible to report the information regarding short selling even if it is not required under new requirements.

⁸ “Ratio of Short Position” means, for any given date, the ratio of the number of relevant shares in the short position to the number of outstanding shares of the issuer as of that date.

⁹ “Number of Short Position Trading Units” means, for any given date, the number of shares in the short position divided by the number of shares in a trading unit of the shares on the relevant stock exchange. It should be noted that the Ratio of Short Position and Number of Short Position Trading Units is required to be calculated in a special ways in some cases. For instance, with respect to a transaction conducted by a person/entity which conducts an Investment Management Business (limited to those defined in Art. 2 (8) (xii) and (xv)), the calculation is required to be made with reference to Investment Property, as defined in Art. 25 (1) (xv) of the FIEA.

¹⁰ For instance, if the Ratio of Short Position changed from 0.21% to 0.29%, the reporting obligation would not be imposed. On the other hand, if the Ratio of Short Position changed from 0.29% to 0.31%, such obligation would be imposed.

Short Position Information under the new regulation.

4. **Permanent Ban on Naked Short Selling¹¹**

While a ban on Naked Short Selling was temporarily introduced in 2008 and extended until present, it has now become permanent. The details of the ban remain unchanged.

5. **Adding Regulations which Cover Transactions Conducted through PTS**

Following the Amendments, transactions conducted through PTS are now also within the scope of the short selling regulations. That is to say, when a trader conducts a short sale through PTS, it will be required to comply with: (a) the ban on Naked Short Selling; (b) notification and confirmation obligations; (c) price regulations; and (d) reporting obligations.

6. **Other Amendments - Narrowing the Scope of Exempted Transactions**

Previously, transactions which were scheduled to be settled by delivery of securities which a trader had purchased but had not settled were exempted from the short selling regulations. However, after the Amendments, transactions will be subject to the short selling regulations where:

- the transaction is scheduled to be settled by delivery of securities; and
- the securities are sold by a broker acting in collusion with a trader who has directed the broker to make a sale of the securities on its behalf.

This amendment is aiming at closing existing loopholes. Previously, the above scenario would have been considered to be proprietary trading on the part of the broker, and the trader would not have been subject to the short selling regulations. However, following the Amendments, the sale directed by the trader will be deemed to be a short sale by the trader through the broker, both of which are subject to the short selling regulations.

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¹¹ The current ban on Naked Short Selling is as follows: When a member securities firm of a stock exchange accepts any order to short sell listed securities from a customer, such securities firm must confirm whether the customer has taken the measures to ensure the definite delivery of the securities, including the execution of a securities lending agreement. The customer shall disclose to the securities firm that he/she has taken such measure in respect of the short selling. If the securities firm cannot confirm that such measures have been taken by the customer, the securities firm may not execute the relevant short sale. A member securities firm of a stock exchange is also prohibited from short selling for its own account unless it takes measures to ensure the definite delivery of the securities.

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Exhibit

