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Enforcement of Insider Trading and Market Manipulation Regulations against Foreign Institutional Investors in Japan

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BIO

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1. Introduction

The Securities and Exchange Surveillance Commission ("SESC"), the enforcement agency for the securities market in Japan, has been very active since 2012 in bringing enforcement actions against foreign hedge fund managers and other institutional investors in relation to cases of insider trading or market manipulation. In Japan, both insider trading and market manipulation constitute violations of the Financial Instruments and Exchange Act ("FIEA"). In 2012, the SESC uncovered a series of manipulative transactions by Tiger Partners LLC ("Tiger Asia"), a company that was managed by Bill Hwang who now manages Archegos Capital Management, which recently caused a sensation after it was found to have incurred massive losses. This article touches upon various topics including the regulatory frameworks under the FIEA as well as the SESC's enforcement activities for the purpose of providing guidance to foreign institutional investors who conduct asset management business in Japan.

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2. Regulatory Framework

2.1 Insider Trading Regulations

The FIEA is modeled after the U.S. Securities Act of 1933 and the U.S. Securities Exchange Act of 1934, but the insider trading regulations are very different from those of the U.S. The U.S. insider trading regulations are formed based on case law relating to the general antifraud provisions of Section 10(b) of the U.S. Securities Exchange Act and Rule 10b-5 thereunder. On the other hand, the FIEA sets out very detailed and complicated requirements in respect of each element of insider trading. For example, the FIEA provides definitions for terms such as "corporate insider" and "material fact", and sets out the requirements for publication of non-public material facts. In general, however, any person who is in possession of non-public material information of a listed company is prohibited from trading shares of that company. The non-public material information of a listed company includes its executive body's decision to conduct, or to start preparations to conduct, a public/private offering or share buyback transaction. In addition, the FIEA sets out insider trading regulations in relation to a tender offer under which any person, who is in possession of non-public information that a purchaser has made a decision regarding a launch of a tender offer of the shares of a listed company, is prohibited from purchasing shares of that company. Furthermore, the 2013 amendments to the FIEA introduced new insider trading regulations regarding the so-called "tipper liability", which prohibits any person in possession of non-public material information from disclosing non-public material information or (without disclosing non-public material information) recommending trades to a third party.

2.2 Market Manipulation Regulations

The U.S. Securities Exchange Act has a specific provision prohibiting manipulative transactions carried out for the purpose of inducing trades by others. In practice, however, the general antifraud provisions that require no such purpose is commonly used in the U.S. SEC's enforcement actions against market manipulations. On the other hand, the FIEA sets out detailed regulations prohibiting various types of market manipulations, including wash trades and matched orders as well as manipulative transactions carried out for the purpose of inducing trades by others. Although the FIEA has a general antifraud provision, it is not applicable to market manipulation. Therefore, in order to bring enforcement actions against cases of suspected manipulative transactions, the SESC is required to establish that such transactions were carried out for the purpose of inducing trades by others. Such purpose is essentially a subjective requirement, but from a practical point of view, it is determined by objective elements such as motives for transactions and trading patterns.

3. Sanctions and Enforcement

The FIEA contains criminal penalties and administrative actions against insider trading and market manipulation. The SESC is authorized to conduct investigations to uncover the FIEA violations, but it has no power to take final actions based on its findings. In criminal cases, the SESC files a criminal complaint to a public prosecutor, who has the power to make an indictment. In administrative cases, the SESC makes a recommendation of an administrative action to the Financial Services Agency ("FSA") who then imposes an administrative monetary surcharge against the wrongdoer. In general, criminal punishment is imposed in high-profile cases, but it is not an ideal enforcement tool for resolving such matters and restoring market confidence in a timely manner. Therefore, the SESC is currently using administrative monetary surcharges as its main enforcement tool.

The FIEA's method of calculating administrative monetary surcharges is formulated on the basis of depriving a violator of the ill-gotten gains that such violator can generally expect to receive at the time of the violation. For example, the expected ill-gotten gains of insider trading to purchase shares will be calculated as the difference between the purchase price and the highest share price during the two week period following the day on which the relevant material fact was made public, irrespective of whether the purchased shares were actually sold or not in the two week period. The SESC or the FSA has no discretion to increase or reduce the amount of the administrative monetary surcharge. This means that the SESC or the FSA will give no credit to a wrongdoer even if such wrongdoer has self-reported an act of misconduct or fully cooperated with the SESC's investigation.

In the case of insider trading, it should be noted that even if there is no intention to make profits or avoid losses by using a non-public material fact, any transaction made by a person in possession of a non-public material fact will generally constitute an act of insider trading under the FIEA. There have been a few enforcement cases relating to unintentional insider trading in the past, but the SESC is now unlikely to bring enforcement actions against such unintentional insider trading because such enforcement would give a chilling effect to the market.

4. SESC's Approach

In the past, the SESC's main target for its enforcement actions were retail investors in Japan. Even when a foreign institutional investor engaged in fraudulent transactions in Japan, the SESC did not conduct any enforcement actions but instead referred the case to the foreign regulatory body supervising the relevant foreign institutional investor. For example, the SESC referred a possible fraudulent transaction of Japan Airlines shares by Oasis Management, a Hong Kong Company, to the Hong Kong Securities and Futures Commission, who then took disciplinary action against Oasis Management in 2011.

In 2011, however, the SESC established a special team for the investigation of fraudulent transactions carried out by domestic and foreign institutional investors and then started actively carrying out investigations on foreign institutional investors who were trading in Japan. The SESC brought an enforcement action against a foreign investor with no footprint in Japan for the first time in 2012. Since then, the SESC has steadily built up a track record of enforcement actions against insider trading and market manipulation by foreign institutional investors.

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5. Case Studies of SESC's Enforcement Actions
5.1. First New York Securities

In June 2012, the SESC found that First New York Securities L.L.C. ("First New York"), a U.S. securities firm, had engaged in an incident of insider trading, and recommended that the FSA issue an administrative monetary surcharge payment order. In June 2013, the FSA imposed an administrative monetary surcharge of JPY14 million against First New York. The SESC alleged that a First New York trader had obtained non-public information about TEPCO's public offering from a salesperson of the lead underwriter through a consulting firm and that First New York sold the shares on its own account before the public announcement.

Under the FIEA, a corporate insider includes an employee of the lead underwriter who has obtained non-public information of a public offering of a listed company in relation to the share subscription agreement between the company and the underwriter. In general, primary recipients who obtain such information from corporate insiders will also be subject to the insider trading regulations. However, secondary recipients who obtain non-public material information from primary recipients are not subject to the insider trading regulations. In this case, the First New York trader could be said to be a secondary recipient because he/she obtained the non-public information through the consulting firm. However, the SESC treated the First New York trader as the primary recipient, finding that the salesperson of the lead underwriter had tipped the consulting firm off about the non-public information with the intention of passing on the non-public information to the consulting firm's client, First New York. First New York initially denied the allegation, but eventually admitted the wrongdoing.

5.2. Tiger Asia

In December 2012, the SESC found that Tiger Asia, an asset manager of two U.S. hedge funds, carried out manipulative transactions of Yahoo Japan shares for the purpose of inducing trades by others and recommended that the FSA issue an administrative surcharge payment order. In January 2013, the FSA imposed an administrative surcharge of JPY65 million against Tiger Asia. Tiger Asia had allegedly inflated the closing share price in the afternoon session on March 17, 2009 by placing discretionary orders with four brokerage firms within a certain range of prices. On the following day, it sold the shares at the inflated share price in response to Yahoo's share buyback announced after the market close of the previous day.

It is important to note that one of the hedge funds under Tiger Asia's management was structured as a Delaware limited partnership ("LP"), and Tiger Asia carried out the manipulative transactions as the general partner of the LP. Under the FIEA, any person is subject to insider trading and market manipulation regulations. However, there is no definition of "person" under the FIEA and it is therefore not clear whether a partnership or LP is subject to the FIEA regulations. In this case, no enforcement action was brought against the LP but the SESC treated Tiger Asia as the person who had violated the FIEA.

In addition, at the time of the violation, the asset managers trading on the account of customers were subject to administrative surcharges as long as they were registered financial firms in Japan. Tiger Asia was not registered in Japan. Therefore, the management fee earned by Tiger Asia was not recognized as ill-gotten gains for the purpose of the administrative surcharge. This big loophole was later blocked by the subsequent 2012 amendments to the FIEA. However, in this case, the SESC found that Tiger Asia had a 4.82% stake in the LP and a corresponding portion of the transactions were then recognized as having been carried out on Tiger Asia's own account for the purpose of calculating the administrative surcharge. This method of calculating administrative surcharges for asset managers of partnership type funds was applied for the first time in this case, and the SESC adopted the same method in subsequent similar cases. In calculating the administrative monetary surcharge, not only Tiger Asia's actual share positions but also its positions in equity swap transactions were factored into the basis of the calculation. Tiger Asia had no footprint in Japan but cooperated with the SESC investigation and did not contest SESC's findings.

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2.3. Prospect Asset Management

In March 2017, the SESC found that Prospect Asset Management, Inc. ("PAMI"), a U.S. SEC-registered investment advisory firm, had engaged in insider trading, and recommended that the FSA issue an administrative surcharge payment order. In June 2017, the FSA imposed an administrative surcharge of JPY3 million against PAMI. PAMI had allegedly purchased Trystage shares while in possession of non-public information relating to the buyback of Trystage shares. Although PAMI appeared to have provided investment advice for a Cayman LP fund on a contractual basis, it was found to have had substantial power to manage the assets in the fund. PAMI's parent company had a 66% stake in the fund and a corresponding portion of the transactions were recognized as having been carried out on PAMI's own account for the purpose of calculating the administrative surcharge. In addition, the remaining portion of the transactions was recognized as being PAMI's transactions for the account of its customers and an administrative surcharge of three times the monthly management fee was imposed in accordance with the 2013 amendment to the FIEA.

6. Final Remarks

The SESC, the watchdog of the security market in Japan, was once seen as a weak enforcer, but it is now actively bringing enforcement actions against errant foreign institutional investors. Therefore, special care should be taken by foreign institutional investors when conducting asset management business in Japan.

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