
Client Alert

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2013 Reform of Short Selling Regulations in Japan

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On November 5, 2013, the amendments to the laws and regulations related to the Financial Instruments and Exchange Law of Japan (the “FIEL”) went into effect, in which regulations concerning short selling in the Japanese marketplace (“Short Selling”) were modified (the “Short Selling Reform”). Short Selling has been subject to an extra layer of regulation, especially after the global financial crisis following the turmoil in the subprime market, due to a concern that such a technique can cause stock prices to plunge further in an already sharply falling market. As the economy recovers from the crisis, the Japanese government has effectively declared that it is now time to get short selling regulations back on a normal track.

A. Short Selling - Background

As covered in news reports, Short Selling has not been issue-free. In Japan, there were multiple cases where Short Selling was said to be conducted as insider trading prior to announcements of large-scale capital raising through public offerings. The Short Selling was also said to be distorting the appropriate price fixing function in public offerings, because there seemed to be excessive price drops after the announcement of public offerings due to Short Selling activities.

The Japanese government has taken measures to respond to these issues. Pursuant to the amendment to the FIEL, which went into effect in December 2011, it is generally prohibited for any investor to participate in a public offering in order to settle the borrowing of securities with respect to Short Selling that was conducted during the period from the announcement of the public offering and the pricing thereof (the “Settlement Prohibition”).

Also, another amendment to the FIEL, which has not yet gone into effect, makes illegal, the transmitting of non-public material information for the purpose of enabling insider trading or encouraging trading while withholding such information. This will place the act of leaking insider information to people who conduct trading of listed stocks, including by way of Short Selling, directly within the scope of illegal acts under the insider trading regulations, in addition to the conducting of insider trading themselves.

While efforts have been made in the past to resolve these issues concerning Short Selling, the Short Selling Reform seems to have taken a separate approach. The Short Selling Reform makes Short Selling per se, as an investment technique, as flexible as possible. The unjust acts in the marketplace have been addressed in an expedited manner, but Short Selling itself has been liberalized taking into account market considerations.

In essence, components of the Short Selling Reform include the following: (i) more flexibility in the short selling price, (ii) permanent ban on naked short selling, (iii) revamped system of reporting/publication of

short positions and (iv) expansion of the scope of the regulations to proprietary trading systems (PTS)^[1]. We summarize below the Short Selling Reform with respect to each of these elements.

B. More Flexibility in Short Selling Price

1. Price Regulation

Prior to the Short Selling Reform, Short Selling had to, at any time, follow a certain price regulation with respect to its selling price. That is, for the purpose of alleviating the downward pressure on the market price, the short selling price was always subject to the “Uptick Rule” where such price may not be (i) at or below the immediately prior selling price (the “Prior Selling Price”)^[2] in a declining market, and (ii) below the Prior Selling Price in a rising market (the “Price Regulation”).

2. Short Selling Reform

The Price Regulation has been drastically modified, with the so-called “Trigger Method” implemented. Basically, the short selling price will not be restricted under the FIEL unless the Price Regulation is triggered under certain conditions.

The effects of the amended Price Regulation, and the triggering events, are as follows:

- i. if there is a price drop of 10% or more from the last closing price (i.e., the closing price on the last trading day) at any stock exchange during its trading hours (the “Trading Hours”)^[3] of a certain day, any Short Selling to be conducted at the same stock exchange will be subject to the Price Regulation for the remainder of the Trading Hours on the same day; and
- ii. if there is a price drop of 10% or more from the last closing price in the main stock exchange (the “Main Stock Exchange”)^[4] during its Trading Hours of a certain day, any Short Selling to be conducted at any stock exchange, including the Main Stock Exchange, during the Trading Hours of the next trading day^[5] will be subject to the Price Regulation;

By implementing this Trigger Method, the short seller (the “Short Seller”) has much greater freedom in conducting the Short Selling because the circumstances in which the Price Regulation is triggered are limited.

^[1] To be specific, these PTSs, opened by licensed financial instruments trading business entities, are limited to those that utilize certain methods for the determination of selling prices.

^[2] The Prior Selling Price means, the price, announced by the stock exchange, most recent to that certain Short Selling. To determine whether it is a rising market or a declining market, the Prior Selling Price is compared to the price, announced by the stock exchange, most recent to the announcement of, and different from, the Prior Selling Price. If such price is below the Prior Selling Price, it is a rising market. If such price is above the Prior Selling Price, it is a declining market.

^[3] The trading hours is set out as from opening to closing of the trading session of the stock exchange based on its business regulation.

^[4] The Main Stock Exchange is defined as the stock exchange with the most stock trading volume, generally with respect to that certain security, for a period of the past six months from the last day of each month.

^[5] For clarity, at the Main Stock Exchange, any Short Selling will be subject to the Price Regulation for the remainder of the day on which the 10% price drop occurs, based on the rule set forth in i. above.

C. Permanent Ban on Naked Short Selling

As is common in other jurisdictions, naked short selling, which means Short Selling without first securing the securities subject to Short Selling, will be permanently prohibited. The ban on naked short selling was previously a temporary measure introduced in the wake of the global financial crisis.

D. Revamped System of Reporting/Publication of Short Positions

The reporting obligation and publication of short positions (the “Short Positions”) held by certain Short Sellers were introduced as a temporary measure after the global financial crisis. These Short Sellers would need to report their Short Positions to the stock exchange, through the securities company that conducted the Short Selling on behalf of the Short Sellers. The stock exchange, in turn, has publicized these reports on a daily basis. The Short Selling Reform makes these measures permanent.

1. Short Selling Reform

The Short Selling Reform implemented a “Two-Tier System” in which there are two thresholds with respect to the reporting and publicizing of Short Positions. Prior to the Short Selling Reform, along with the requirement to have more than a certain number of short selling balance units, a Short Seller having a short selling balance ratio (the “Short Selling Balance Ratio”)^[6] of 0.25% had to report its Short Position, which was subsequently disclosed to the public by the stock exchange. The Short Selling Reform stipulates that, with respect to the Short Selling Balance Ratio, there will be different percentage thresholds for reporting and publication as the following:

- i. Short Positions having a Short Selling Balance Ratio of 0.2% will need to be reported; and
- ii. Short Positions having a Short Selling Balance Ratio of 0.5% will be publicized by the Main Stock Exchange.

This reporting/publicizing will continue to play a role in monitoring the Short Selling activities in the marketplace, while the Short Selling Reform limits the information disseminated to other players in the marketplace regarding such activities.

2. Reporting Requirements regarding Changes

The reporting requirements with regard to changes in Short Positions have been modified as well. Previously, the reporting obligation was triggered by any changes to the Short Selling Balance Ratio; however, the new rules require the reporting of changes, with respect to the Short Selling Balance Ratio, at every 0.1% increase from the reporting threshold of 0.2%, or when such ratio falls below 0.2%.

E. Expansion of Scope of Regulations to PTS

Effective with the Short Selling Reform, regulations concerning Short Selling will now also cover the PTS. As a result, any of the following regulations will be applicable to PTS, in the same way as to Short Selling through the stock exchanges.

- i. the obligation to inform/obligation to confirm whether the transaction is Short Selling;

^[6] For the purpose of calculating the Short Selling Balance Ratio, generally speaking, the balance of shares subject to Short Selling at the end of a trading day will be divided by the issued shares of that certain company.

- ii. the Price Regulation;
- iii. the reporting/publication of Short Positions;
- iv. the prohibition on naked short selling; and
- v. the Settlement Prohibition.

F. Conclusion

In summary, the regulations concerning Short Selling have become wider in scope by covering the PTS, but they are now more flexible, with less publication, from the investors' perspective.

In the post-financial crisis regime, this flexibility in the hands of investors will hopefully further invigorate the economy.

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