The Review of Insider Trading Regulation

Following Recent Violations and Other Developments

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Working Group on Insider Trading Regulation

“Working Group on Insider Trading Regulation” Member List

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Preface

The existing insider trading regulation is designed to prohibit a person who is in a privileged position to obtain inside corporate information from making securities transactions with the knowledge of unpublished Material Facts,[1] which could gravely undermine investor confidence in the fairness and soundness of securities markets. On the other hand, with respect to the disclosure of inside information which induces insider trading, no specific regulations exist, although those acts may constitute a crime of aiding and abetting an insider trading.

However, looking at recent insider trading cases, many were conducted by people receiving information from Corporate Insiders[2] and TOB Insiders.[3] There have even been cases of insider trading conducted on information leaked by the lead underwriters (securities companies) during a listed company's public offering process. Another issue highlighted by these cases is that, where an asset manager has committed the violation on a customer's account, the monetary penalty amount was woefully inadequate for effective deterrence.

The Working Group on Insider Trading Regulation has held seven sessions since July 2012 to deliberate on ways to address the issues highlighted by these recent cases of insider trading, and to review the insider trading regulation in light of recent developments in the financial and corporate practices.

This Report compiles the results of these deliberations by the Working Group. It is hoped that appropriate steps are taken by relevant parties for the development of a regulatory framework, building on the findings of this report.

[1] "Material Facts" are defined under Article 166(2) of the Financial Instruments and Exchange Act (FIEA).
[2] "Corporate Insiders" are defined under FIEA Article 166(1).
[3] "TOB Insiders" mean "Persons Concerned with Tender Offeror, etc." as defined under FIEA Article 167(1).

I. Regulation of Disclosure of Inside Information and Trading Recommendations

1. Introduction

Observing the recent insider trading cases in which the Securities and Exchange Surveillance Commission (SESC) either made a recommendation to apply monetary penalty or to pursue criminal prosecution, instances of violation committed by the recipients of information from Corporate Insiders or from TOB Insiders have increased, and such instances now constitute the majority of the violations. There have also been insider trading cases where inside information was leaked by sales staffs of the lead underwriter involved in the public offering of a listed company.

Without the disclosure of inside information, recipients of the information would not have engaged in insider trading. Therefore, deterring an improper disclosure of inside information has become a critical issue for the prevention of insider trading.

2. Regulation of disclosure of inside information and trading recommendations

(1) Regulation of the disclosure of inside information

When a person conducts a trade in possession of an unpublished Material Fact of a listed company, that person would have significant advantage over ordinary investors unaware of such information. Such trading could undermine investor confidence in the securities market.

The disclosure of inside information which facilitates such tradings would increase the chance of trading being conducted by persons in possession of unpublished Material Facts, and it allows those persons who are in a privileged position close to an insider to trade on a favorable condition. As a result, the investor confidence in the securities market could be undermined, and therefore appropriate deterrence measures need to be introduced.

Note: In the United States and in Europe, certain acts of inside information disclosure are regulated. In the United States, the scope of regulation is limited to cases where the recipient of information has actually made a transaction. In France and Germany, while certain acts of inside information disclosure is regulated regardless of whether or not the trade has been conducted, in practice, sanctions have been imposed in cases where the recipient of information had traded.

Furthermore, in Europe, current regulation extends to certain acts of trading recommendations. In the United States, these acts may also be covered by the regulation, but only in cases where a trade had been conducted.

(2) Regulation of trading recommendations

Even if the acts of inside information disclosure were regulated, there would still be a possibility for a person to induce the trade to take place, without disclosing inside information, by implying the existence of unpublished Material Facts or by indicating that they are in a position to obtain such facts.

Furthermore, if a person, who is in a privileged position to acquire inside information, recommends trading with the knowledge of inside information, the person receiving the recommendation may be incentivized to trade, resulting in a trade upon unpublished Material Facts. As such trading recommendations could adversely affect the investor confidence in the securities markets, appropriate deterrence measures to prevent improper trading recommendations are also required.

(3) Scope of regulation

In principle, the regulation applies to the disclosure of inside information/trading recommendations performed by Corporate Insiders, who are subject to insider trading regulation (or by TOB Insiders in the case of insider trading regulation for TOB Insider (FIEA Article 167)). However, so as not to disrupt normal business activities of listed companies, and taking into account the purpose of the FIEA, it would be appropriate to limit the scope of the regulation to improper disclosure of inside information/trading recommendations relating to securities market and financial instruments transactions, which fulfills the following requirements:

(i) Subjective requirement

Listed companies exchange information in a variety of circumstances, for instance, during business alliance negotiations or for investor presentations (so-called “IR activities”). Therefore, it has been suggested that the overall regulation including all forms of inside information disclosure/trading recommendations in the scope of the regulation would disrupt normal business activities of the company.

Without impeding the disclosure of inside information/trading recommendations as conducted by companies during the course of their normal business activities, in order to regulate improper disclosure of inside information/trading recommendations which may likely facilitate trading upon unpublished Material Facts, it is appropriate to establish subjective requirements, such as “the intention to encourage the recipient of information to trade” while also taking into account the authorities’ ability to prove such requirements.

(ii) Trading requirement

The aim of the regulation for disclosure of inside information/trading recommendations is to prevent a situation where improper inside information disclosure/trading recommendations results in a trade upon unpublished Material Facts. Therefore, priority may not be as high to penalize instances where receiving the improperly disclosed inside information or trade recommendation has not been a factor in the investment decision. Furthermore, if a mere disclosure of inside information/trading recommendations were made subject to criminal and/or monetary penalty, normal business activities which should not be subject to sanctions could be adversely affected. In light of this, it is appropriate to establish trading requirement such that an insider trading has taken place with the improper disclosure of inside information/trading recommendations being a factor in the investment decision.

3. Deterrence measures against violations (enforcement)

(1) Deterrence measures against violations

For the purpose of deterring violations and ensuring the effectiveness of the regulations, it is appropriate to introduce enforcement measures similar to current regulations for market abuse (criminal sanctions and monetary penalties).

As the current monetary penalty regime is based on the disgorgement of the profit obtained from the violation, it would be appropriate to set the amount of the monetary penalty equivalent to the profit obtained by persons engaged in information disclosure or trade recommendations.

(2) Persons engaged in the brokerage of listed securities (securities brokers)

In order for the securities markets to fully function, it is necessary to protect investor confidence in the markets by ensuring a fair trading environment. Persons engaged in the brokerage of listed securities (securities brokers) assume a highly public role as the gatekeeper of the securities markets, and their position requires that they actively seek to prevent market abuse and to maintain fairness and soundness of the markets, through such means as monitoring their customers' trading. If an officer or an employee of a broker discloses inside corporate information or recommends trading upon inside information to select customers in the course of his/her profession, it could result in a loss of trust in not only the broker but also our securities market overall.

Considering the importance of the role played by the brokers, it is necessary that enforcement measures against violations by brokers offer more effective deterrence as those listed below.

(i) Calculation formula for monetary penalty

Where an officer or employee of a broker improperly discloses inside information or makes a trading recommendation in the course of his/her business and a trade results from such broker action being a factor in the investment decision, it would be appropriate to apply a formula that confers a stronger deterrent effect which takes into account the fact that a broker typically has wider range of profit from the violation in the course of its business. (For example, the penalty could be upon trading commissions received repeatedly from the institutional investors as a result of their periodical (e.g., quarterly) broker rating reviews, or, in the case of a violation relating to public offerings, the underwriting commission from the distribution.)

(ii) Publication of the offender's name as a warning

If an officer or employee of a broker commits a violation in the course of his/her business, the monetary penalty is imposed on the broker, rather than the individual officer or employee who disclosed the inside information or made the trade recommendation. In such cases, as there is a possibility for the officer or employee to commit violations repeatedly, it is appropriate to publish the names of the officers and employees who had committed the violation (but excluding those who only played a supplementary role) in order to warn future potential trade counterparties, such as securities companies and investors, and to deter violations.

In addition, regardless of whether or not the above-mentioned subjective requirement or trading requirement is satisfied, the officer or employee of a broker must not improperly disclose inside information or recommend trading for the purpose of promoting the business. With respect to this point, since solicitation by providing confidential corporate information is prohibited under the existing business regulations, basically, it would be appropriate to achieve deterrence against such acts through application of these business regulations while ensuring consistency with the above-mentioned regulation regarding inappropriate information disclosure/trading recommendations.

(3) Acts of demanding Material Facts

With regard to the insider trading cases relating to the public offerings, authorities became aware of hedge fund managers strengthening their influence over securities companies through the practice of broker rating reviews which determine the volume of trading orders by the managers to a securities company, and continuously and repeatedly demanding the securities companies to provide them with “useful information.”

While such behavior is a preliminary act for insider trading, given that its aim is to solicit inappropriate disclosure of information leading to active insider trading, it is highly malicious and therefore requires an effective deterrence.

From this perspective, in cases where institutional fund managers engage in insider trading by taking advantage of their business relationships to demand unpublished Material Facts, it is appropriate to warn future potential trade counterparties, such as securities companies and investors, by publishing the names of the persons who played a central role in the violation.

Furthermore, in addition to those cases mentioned above, it is also appropriate to warn future potential trade counterparties, such as securities companies and investors, by publishing the names of persons who have repeatedly committed market abuse violations, such as insider trading, in order to deter further violations, given the possibility that these persons may continue to commit further violations.

II. Reform of Monetary Penalty Regime for Violations Committed by Asset Managers “on Client Accounts”

1. Introduction

The monetary penalty regime for market abuse was introduced under the 2004 amendment of the former Securities and Exchange Act (replaced by the FIEA) to deter violations and to ensure the effectiveness of the regulation. Then, as a result of the 2008 amendment of the FIEA, in addition to market abuse committed using “proprietary trade account,” the scope of monetary penalty was extended to include market abuse committed using “client accounts.”

Under the current regime, if an insider trading was conducted “on client accounts,” monetary penalty imposed would be equal to the fees, remuneration, and any other considerations received for the trade (as specified in the Cabinet Office Ordinance). Cabinet Office Ordinance stipulates that: (i) where a violation has been committed as part of the asset management activity, the monetary penalty would be “remuneration received for the month in which the violation took place” multiplied by “the ratio of the value of the relevant stocks to the total Assets Under Management”; and (ii) where a violation was committed in a manner other than that described under (i), the monetary penalty would be equal to “the proceeds from the violation.”

The monetary penalty regime is an administrative measure of imposing financial burdens on offenders for the purpose of deterring violations. To this end, monetary penalty needs to be of sufficient magnitude to deter violations and to ensure effectiveness of the regulation. However, in light of the recent violation cases, current calculation formula of monetary penalties for violations committed “on client accounts” appears to be insufficient to deter offences. Therefore, it is appropriate to review the formula so that the formula properly captures the gains that an offender would normally obtain.

2. Gains of a person committing the violation “on client accounts”

Persons typically regarded as having the potential to commit violation “on client accounts” are: (i) persons who engage in the business of asset management pursuant to a mandate (i.e., asset managers); and (ii) persons who primarily engage in one-off trading, including persons not engaged in the business of asset management.

With regard to (i), asset managers are able to continue receiving management fees generated from the violation, and it is thought that the gains would arise not only from the management fee itself for the stocks relevant to the violations but also from the overall management fee received from their client.

Therefore, the current calculation formula for monetary penalty does not adequately capture the gains generally yielded by asset managers. As the asset management mandate is a continuous agreement, if a mandate has been concluded between an investor and an asset manager, it would be possible for the asset manager to continue receiving the management fee for a considerable period of time. As such, it is appropriate to review the calculation formula for monetary penalty so that the amount is based on management fees receivable over a certain period (e.g., three months).

On the other hand, with regard to (ii), since the direct remuneration arising from the violation can be regarded as the gains that could generally be yielded by the offender, the current calculation formula in which the gains from the violation are used as the basis for monetary penalty remains appropriate.

3. Calculation formula for the gains of the offender

In cases where, for instance, an offender manages an overseas fund established by and involving several group companies, it is possible that the authority is not able to unveil the detailed information of the fund and of the profits gained by the offender, which are required for calculating the monetary penalty, even after the investigation. In such a case, if the monetary penalty cannot be calculated or imposed even if the facts of the violation are undisputed, it would be insufficient for deterrence purposes, and may run the risk of evasive schemes being devised to avoid monetary penalty investigations.

Therefore, it would be appropriate to consider ways to calculate the monetary penalty even for cases where despite the offence being recognized, monetary penalty cannot be calculated due to lack of required data.

4. Other issues

Some members have suggested that, from the perspective of effective deterrence, it would not be necessary to limit the scope of the monetary penalty to gains obtained by the offender as the purpose of the monetary penalty regime is to deter the violations from being committed. The Working Group has reviewed and deliberated on the calculation formula for monetary penalty within the framework of the existing monetary penalty regime, which is based on the gains obtained from the violation, focusing on the specific case where the offence has been committed “on client accounts.” However, the nature of the current monetary penalty regime itself is also an important issue that warrants a review in the future.

III. Reform of Regulation in the Light of Recent Financial and Corporate Practices

1. Expansion of the scope of the term TOB Insiders

(1) Current issues

Recent cases of insider trading involving TOB Insider (FIEA Article 167(1)) have shown an increase in insider trading by officers or employees of the company subject to the tender offer (the offeree company) and by recipients of information from them. In many of the monetary penalty cases thus far, the offeree company and its officers or employees have been determined as TOB Insiders, based on the conclusion of confidentiality agreements and other agreements with the offeror.

However, since the current regime does not recognize the offeree company and its officers or employees as TOB Insiders by virtue of being in such positions, it is not necessarily possible to determine the offeree company and its officers or employees to be TOB Insiders in all cases.

(2) Required response

In Japan, the majority of tender offers are non-hostile, being conducted with prior agreement between the offeror and the offeree company. Even in the case of hostile tender offers, in most cases, the offeror tends to notify the offeree company of the facts concerning the tender offer ahead of its public announcement, in order to gauge the offeree management's level of support. Furthermore, in the cases of acts of buying up 5% or more of the shares, the acquirer may disclose to the offeree company the facts of increasing the stake in the offeree company prior to the public announcement, particularly if the person has the intention to influence the management of the offeree company.

As such, the offeree company and its officers or employees may be considered as being in a privileged position to acquire unpublished Tender Offer Facts[4] through the disclosed information by the offeror. Therefore, it is appropriate to include them in the definition of TOB Insider and to regulate them.

2. Exemption of trades conducted by the recipients of Tender Offer Facts

(1) Current issues

Under insider trading regulation pertaining to TOB Insiders, a recipient of unpublished Tender Offer Facts, in principle, cannot purchase shares of the offeree company until the offeror publishes the Tender Offer Facts. It has been pointed out that therefore, for

[4] "Tender Offer Facts" mean "Facts Concerning Tender Offer, etc." as defined under FIEA Article 167(3).

instance, if a person, who has decided to buy out a listed company, discloses unpublished Tender Offer Facts to other potential acquirers, this would prevent them from increasing their stake.

From the perspective of promoting fair competition with respect to mergers and acquisitions and facilitating an orderly securities trading, it would be appropriate for the recipients of unpublished Tender Offer Facts be allowed to purchase shares of the offeree company where investor confidence in the securities markets would not be harmed.

(2) Required response

Taking into account the intended purpose of the regulation that prohibits a person, who is in possession of unpublished Tender Offer Facts, from purchasing shares of the offeree company, it is appropriate to permit the recipient of information to purchase shares under the following cases: (i) where a trading advantage by the recipients of information over ordinary investors has been eliminated to a considerable degree, and (ii) where the information received by the recipients of information has lost its usefulness in making investment decisions.

(i) Cases where a trading advantage has been eliminated to a considerable degree

When a recipient of unpublished facts relating to Tender Offer Facts makes his/her own tender offer, he/she is required to submit and make available for public viewing a Public Notice for Commencing Tender Offer and a Tender Offer Notification under tender offer regulations (FIEA Article 27-3, etc.). If the recipient describes the information he/she has received in these documents, the trading advantage over ordinary investors would be eliminated to a considerable degree, and therefore, it would be appropriate to allow the trading by the recipient of information.

Another issue is whether to establish a similar framework in cases where the recipient of information intends to buy up 5% or more of the shares without conducting tender offers. This is an issue to be considered in the future while ascertaining how "plans adopted before becoming aware of Material Facts/Tender Offer Facts" mentioned below would actually be used, and how business practice would be operated based on this framework of regulatory exemption, including such questions as whether there are any conceivable means that are similar to Public Notices for Commencing Tender Offer and Tender Offer Notifications.

(ii) Cases where information has lost its usefulness

In general, tender offers are announced and implemented within a short time frame once the decision for implementation has been made. As such, where the unpublished Tender Offer Facts are not published by the offeror even after a considerable period of time has passed since a recipient of information had received them, the value of such information would deteriorate and it would be unlikely for the recipient of information to make an investment decision based on unpublished Tender Offer Facts received in the past.

Therefore, so as to prevent a recipient of unpublished Tender Offer Facts from being placed in a precarious position where he/she can never trade, it would be appropriate to enable trading by recipients of information in cases where a considerable period of time has passed since the recipient of information last received the information (e.g., six months).

(iii) Current regulatory exemption

In addition to the above-mentioned reforms, in light of the fact that the current regulatory exemptions for competing purchases (FIEA Articles 166(6)(iv) and 167(5)(v)) are allegedly difficult to use in practice, it is appropriate to work on clarifying the interpretation of the regulations.

3. Exemption related to trades conducted between persons in possession of Material Facts

(1) Current issues

The existing FIEA exempts over-the-counter or negotiated transaction conducted between specific persons who possess unpublished Material Facts pertaining to a listed company from insider trading regulation (FIEA Article 166(6) (vii)). Under the current law, trading conducted between a Corporate Insider and a primary recipient of information is exempted from the regulation, while trading between the primary recipient of information and a secondary recipient of information is not included.

(2) Required response

From the perspective of eliminating obstacles under the current regulation whereby cumbersome procedures need to be followed, such as when a large shareholder conducts block trades at off-the-market for the purpose of reducing its shareholding, it is appropriate for direct trading conducted between a primary recipient of information and a secondary recipient of information in possession of Material Facts to also be included in the regulatory exemption, while paying attention so that the regulatory exemptions are not abused.

4. Exemption of trades based on contracts concluded and plans adopted before becoming aware of Material Facts/Tender Offer Facts

(1) Current issues

Even if a person is in possession of unpublished Material Facts pertaining to a listed company, where it is obvious that trading is conducted with no relation to the possession of Material Facts, investor confidence in the securities markets would not be undermined, and FIEA exempts from insider trading regulation such trades as specifically listed in the Cabinet Office Ordinance.

To ensure clarity in the scope of this exemption, the trades eligible for exemption have been specifically prescribed and as trades not conforming to these types were not exempted, practical issues have arisen for such as trades between counterparties other than listed companies that trade based on contracts concluded and plans adopted before becoming aware of Material Facts/Tender Offer Facts (FIEA Articles 166(6)(viii) and 167(5)(viii)).

(2) Required response

From the perspective of ensuring efficient trading, it is appropriate to clarify the basic concept based on the following viewpoints, establish more comprehensive provisions for regulatory exemption and indicate interpretations of laws and regulations in advance by means of guidelines as necessary:

- the contract/plan was concluded/adopted before becoming aware of undisclosed Material Facts/Tender Offer Facts;
- the contract/plan stipulates specific details of the trade to be conducted, for example, and that it is not a discretionary trade; or
- the trade is in accordance with the contract/plan.

In conducting the above-mentioned reform, consideration needs to be given to the risk of the contract or plan being fabricated *ex post*. With respect to this point, if the contract or plan prescribes that trading is conducted repeatedly or continuously, then the risk of it being fabricated afterwards is typically low. Furthermore, even if the contract or plan prescribes for one-off trading, as long as some measures are taken making it clear that the contract/plan was concluded/adopted before becoming aware of unpublished Material Facts (e.g., confirmation by a securities company), then the risk of the contract or plan being fabricated would be low. Building on these viewpoints, an appropriate regime needs to be developed.

IV. Other Preventive Measures against Insider Trading

1. Introduction

In order to prevent trading upon unpublished Material Facts as well as improper disclosure of inside information/trading recommendations which leads to a trade, apart from the statutory regulation, each market participants should play their role within the market and to create a market environment that prevents the occurrence of market abuse.

2. Measures by the Financial Services Agency (FSA) and the Securities and Exchange Surveillance Commission (SESC)

From the perspective of promoting general prevention of violations while avoiding unnecessary chilling effect on corporate activity, for example, it is appropriate to make the current published collection of monetary penalty cases more useful to serve as a reference.

3. Measures by the financial industry

Securities companies need to strive to restore investor confidence by continuing their efforts, including reviewing and improving their management systems for confidential corporate information.

Furthermore, self-regulatory organizations need to work to revise their self-regulatory rules, strengthen their enforcement and review sales practices and customs with a view to improving the compliance system and the quality of information management in the entire financial industry.

4. Measures by the financial instruments exchanges

Financial instruments exchanges need to ensure market fairness and to maintain a fair trade environment by promoting best practices in information management and providing warnings to listed companies to which persons who improperly disclosed inside information belong.

Furthermore, financial instruments exchanges also need to consider ways so that, in cases where a scoop has been reported on a Material Fact pertaining to a listed company, the listed company discloses more in-depth information on the facts pertaining to the report. While considering this, it is also appropriate to consider whether the disclosures of information which satisfy certain conditions possibly fall under the “publication” measures of Material Facts (FIEA Article 166(4)) by which insider trading regulation is removed.