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Japan Regulatory Update

Japan

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Understanding the Obligations of Financial Instruments Business Operators with respect to Corporate Information

A. BACKGROUND

Based on the recommendation made by the Securities and Exchange Surveillance Commission of Japan on December 15, 2015, the Financial Services Agency of Japan (the "**Japan FSA**") imposed an administrative sanction against Deutsche Securities Inc. for violating:

(1) the duty of a financial instruments business operator to properly manage and control any Corporate Information it possessed;[1] and

(2) the prohibition of a financial instruments business operator from disclosing Corporate Information to a third party for the purpose of soliciting securities transactions, securities derivative transactions, etc. (collectively "**Securities Transactions**"). [2]

As defined in the FIEA, "**Corporate Information"** (*houjin kankei jyouhou*) refers to any undisclosed material information with respect to a listed company's operation, business or assets that may influence an investment decision of investors[3].[4]

Subsequently, on April 25, 2016, the Japan FSA imposed an administrative sanction against Credit Suisse Securities (Japan) Limited for violation of the identical obligations as Deutsche Securities Inc.

These two consecutive actions by the Japan regulators against leading securities firms in Japan have raised some significant concerns among financial institutions, securities firms and investment fund managers – particularly given the suspected connection of these sanctions with the practice of "preview meetings" in Japan.

In light of these recent events, the topic of this Client Alert will be to provide a brief summary of the obligations of financial instruments business operators with respect to Corporate Information. Furthermore, we will seek to distinguish this particular duty of financial instruments business operators regarding Corporate Information from the general prohibition on trading based on "Material Information" as relevant to insider

1 Article 40, Item 2 of the Financial Instruments and Exchange Act of Japan (the "**FIEA**"), Article 123, Paragraph 1, Item 5 of the Cabinet Ordinance concerning Financial Instruments Business etc. (the "**Cabinet Ordinance"**)

2 Article 38, Item 7 of the FIEA (as of April 1, 2016, this provision was amended to Article 38, Item 8), Article 117, Paragraph 1, Item 14 of the Cabinet Ordinance.

3 In addition, "**Corporate Information**" also covers non-public information regarding the implementation or cancellation of tender offer bid.

4 As set forth in Article 1, Paragraph 4, Item 14 of the Cabinet Ordinance.

trading under the FIEA.

We do wish to note that this Client Alert will not specifically seek to cover under what circumstances may certain types of information disclosed by an issuer at a "preview meeting" be deemed as Corporate Information.

B. THE PROPER HANDLING OF CORPORATE INFORMATION AND PROHIBITED BUSINESS ACTIVITIES WITH RESPECT TO CORPORATE INFORMATION

Article 40, Item 2 of the FIEA and relevant provisions of the Cabinet Ordinance provide a comprehensive duty on any financial instruments business operator (such as a securities company, discretionary investment manager or investment advisor) to establish an adequate internal system to manage and properly handle any Corporate Information that it may receive for the purpose of preventing such financial instruments business operator from engaging in an unfair or inappropriate transactions using such Corporate Information.

Separate from the general obligation described above, financial instruments business operators are explicitly prohibited from engaging in certain types of activities in relation to Corporate Information under Article 38, Item 8 of the FIEA and relevant provisions of the Cabinet Ordinance, such as:

- disclosing Corporate Information to a third party for the purpose of soliciting Securities Transactions;[5]
- using Corporate Information to make recommendations to a third party with respect to solicitation of a Securities Transactions prior to such Corporate Information being publicly available for the purpose of providing a benefit to the third party or for the purpose of such third party avoiding certain losses;[6] and
- a Type 1 Financial Instruments Dealer is prohibited from using Corporate Information in relation to the sale or purchase of securities, etc. for its own account (including individuals employed by such financial instruments business operator).[7]

C. COMPARISON TO INSIDER TRADING REGULATIONS

While there is an overlap in the concept between the rules and regulations governing Corporate Information and "Material Information" as used in relation to the prohibition on insider trading (i.e. prohibition on trading using information that is not available to the public), it is critical to note that the rules and regulations with respect to insider trading are distinct and separate from the obligations of a financial instruments business operator under Japanese law.

1. Scope: Corporate Information vs Material Information

As defined under the FIEA, the scope of Corporate Information is more subjective and broader than that of Material Information under the insider trading rules and regulations.

"**Material Information**" is explicitly defined under the FIEA to cover specific types of information (e.g. decision driven information, event driven information, etc.). Furthermore, the definition of Material Information contains a basket clause which is similar to the definition of Corporate Information, which reads "all other information with respect to a listed company's operations, business or assets

5 Article 117, Paragraph 1, Item 14 of the Cabinet Ordinance

6 Article 117, Paragraph 1, Item 14-2 of the Cabinet Ordinance

7 Article 117, Paragraph 1, Item 16 of the Cabinet Ordinance

that may **significantly** influence the investment decision of investors".[8]

On the other hand, the concept of Corporate Information: (i) has no specifically enumerated list of the types of information deemed to be Corporate Information; (ii) there is no prescribed method as to how Corporate Information must become "public"; and (iii) has no requirement that the influence of Corporate Information on the investment decision of an investor be "significant".

It is generally held that any Material Information of a listed company should be deemed Corporate Information but given the respective definitions, not all Corporate Information should be viewed as Material Information.

2. Application

Irrespective of the similarities in definitions, it is important to note that there is a fundamental difference in the application of the rules governing Corporate Information and Material Information.

While the rules of insider trading are applicable to anyone that trades specified securities, etc. (and the recipients of Material Information), the duty to properly handle Corporate Information is limited solely to financial instruments business operators.[9] In other words, any entity that is not registered with the Japan FSA as a financial instruments business operator is not subject to the obligations in relation to Corporate Information under the FIEA and cannot be sanctioned in the manner as Deutsche Securities Inc. and Credit Suisse Securities (Japan) Limited. In fact, provided that Corporate Information received by an entity that is not a registered financial instruments business operator does not also constitute Material Information, such entity is not directly restricted to make trades on any Corporate Information that it receives – even if such information was received as a result of the breach of the duties of a financial instruments business operator.

Based on the above, the penalties that may be imposed with respect to violations of Article 38, Item 8 or Article 40, Item 2 are only applicable to financial instruments business operators and are in the form of administrative penalties (i.e. not criminal penalties).

D. CONCLUSION

As discussed herein, the duties of a financial instruments business operator to properly manage Corporate Information is a separate and distinct obligation from the general prohibition of trading using Material Information under the insider trading rules of Japan – with the key difference being its application as this obligation is only applicable to registered financial instruments business operators and no one else.

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8 Article 166, Paragraph 2 of the FIEA. (emphasis added)

9 In addition to financial instruments business operators, intermediaries of financial instruments business operators and transaction-at-exchange operator are also subject to these obligations.

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