

lakyara vol.295

Materiality in criminal misrepresentation in securities filings

Sadakazu Osaki

10.January.2019

**Sadakazu Osaki***Fellow, Head of Research*Center for Strategic
Management & Innovation**NOTE**

1) https://www.fsa.go.jp/sesc/news/c_2018/2018/20181210-1.htm

2) Shibahara, Kuniji et al., eds., *Keizai keiho: jitsumu to riron (Economic Criminal Law: Practice and Theory)*, Shojihomu (2017), pp. 512-521.

3) Shibahara, Kuniji, *Keizai keiho kenkyu (gekan) (Economic Criminal Law Research (vol. 2))*, Yuhikaku Publishing (2005), p. 624.

Charges filed against Carlos Ghosn et al.

On December 10, 2018, Nissan Motor's former chairman Carlos Ghosn, another Nissan executive and Nissan itself were indicted for allegedly violating Japan's Financial Instruments and Exchange Act (FIEA) by filing Annual Securities Reports containing misrepresentations. With the media reporting conflicting accounts and the facts of the case yet to be spelled out in detail, it is too early to safely draw any conclusions about the allegations against Ghosn and his codefendants.

That said, at least one of the allegations seems more or less indisputable. Namely, the amounts of Ghosn's monetary and total compensation disclosed together with other board members' compensation in the corporate governance section of Nissan's Annual Securities Reports differed from their actual amounts. According to a statement issued by the Securities and Exchange Surveillance Commission (SESC), which filed an accusation against Ghosn and his codefendants with public prosecutors on December 10, the discrepancies between actual and disclosed compensation constitute the criminal offense of filing a false Annual Securities Report in violation of the FIEA (Article 197(1)(i))¹⁾.

I recently happened to delve fairly deeply into criminal misrepresentation in securities filings while authoring a commentary on the topic for a legal book published in 2017²⁾. Hypothetically assuming that Nissan's securities filings did in fact understate Ghosn's compensation, I would like to share some information relevant to whether such an understatement could constitute a criminal violation of the FIEA. The following is largely a reiteration of my contribution to the aforementioned book.

Misrepresentations are a crime only if material

The FEIA imposes criminal penalties on "misrepresentations of material matters" in statutory securities filings, most notably Annual Securities Reports among other disclosure documents. A "misrepresentation" in this context means a disclosure inconsistent with the actual facts, but the mere existence of such an inconsistency in an Annual Securities Report would not automatically constitute the crime of filing a false Annual Securities Report. To be punishable as a crime, the inconsistency must pertain to a "material matter," meaning a matter consequential enough to influence the typical investor's investment decisions³⁾. In other words, would investors' investment decisions differ depending on whether or not they knew the true facts of the matter in question?

4) Tsuchimochi, Toshihiro et al. in Hirano, Ryuichi et al., eds., *Chukai tokubetsu keiho, hokan (2) (Annotated Special Criminal Law, Supplement (2))*, Seirin Shoin (1996), p. 67; Yanaga, Masao, *Kansanin ni tsuki kyogi kisai yuka shoken hokokusho teishutsuzai nado no kyodo seihan ga seiritsu suru to sareta jian (Cases in which Corporate Auditors Were Criminally Charged as Co-principals for Filing a False Securities Report)*, *Juristo (Jurist) No. 1405* (2010), p. 130.

Specific materiality determinations are ultimately made on a case-by-case basis in accord with societal norms⁴⁾. Trivial misstatements such as obvious typographical errors or omissions are generally not deemed material. Though it is not uncommon for a company to file an amended Securities Report or other disclosure documents to correct even such minor errors and omissions, they are never treated as illegal misrepresentations.

Textbook case is doctored financial statements

The classic example of criminal misrepresentation of a material matter is falsification of the income statement, balance sheet and/or other financial statement contained in statutory disclosure documents. The most common methods of falsifying financial statements include overstating revenues by means of fictitious transactions, padding profits by understating expenses, and overvaluing assets.

Major companies criminally convicted for securities filings containing falsified financial statements include Tokyo Clock Mfg. (1976), Nippon Thermal Engineering (1977), Sanyo Special Steel (1978), Fujisash (1982), Riccar (1987), Yamaichi Securities (2000), Kanebo (2006), Cats (2010), Livedoor (2011) and Olympus (2013). In another well-known recent case, Toshiba received administrative monetary penalty, though not criminally charged, in 2015.

Material misrepresentation not involving financial statements: Seibu Railway case

Perhaps because “cooking the books” figures so prominently in the most infamous previous cases of misrepresentation in statutory securities filings, some reporters and commentators have argued that Nissan is not guilty of falsifying its financial statements even if its accounting treatment of compensation payable to Ghosh was improper. However, criminal misrepresentation does not necessarily have to involve financial statements. As mentioned above, the SESC’s accusation took issue with the total amount of corporate officer compensation that should have been reported in the corporate governance section of Nissan’s Securities Report relative to the amount that was reported. It made no mention of said compensation’s accounting treatment or Nissan’s financial statements.

Among past cases, the highest-profile conviction for a misrepresentation in a statutory securities filing that did not involve a financial statement was the Seibu Railway case (2005). The defendant, a representative director of Company

A, colluded with the representative directors of Company B, a publicly traded company 64.83% owned by Company A, to file Annual Securities Reports falsely stating that a portion of Company A's shareholdings in Company B was under third-party ownership.

The court ruled that Company A's ownership stake in Company B was clearly a material fact likely to heavily influence investors' investment decisions. The rationale behind its ruling was that if not for the misrepresentation, investors would have known that (1) Company B was Company A's subsidiary, (2) regular investors had no virtually prospect of gaining any say in Company B's management, (3) Company B's stock was much less liquid than purported and (4) Company B could have even been delisted if its top-10 shareholders and related parties' aggregate ownership stake were to exceed the 80% delisting threshold then in effect under Tokyo Stock Exchanges' listing standards.

Other cases

While the Seibu Railway case is the only criminal case of its kind, there are at least a couple of similar non-criminal cases. In one such case, Sanei Architecture Planning received administrative monetary penalty in 2014 for a securities filing that misrepresented the number of its shares owned by its CEO, who was a major shareholder. In a second, more interesting case that likewise did not involve financial statement falsification, Optrom received administrative monetary penalty in 2017 for material misrepresentation.

Optrom had hired a credit research firm to investigate a company to which it planned to issue shares through a private placement offering. The credit research firm reported that the parent company of Optrom's prospective equity-offering counterparty was connected with individuals suspected of being involved in organized crime and other illegalities. It advised Optrom against issuing shares to the counterparty on suitability grounds. Optrom not only omitted these facts from its disclosure statement for the equity offering, it also expressly denied having any information indicating that the prospective counterparty's major shareholders were linked to organized crime or illegal activities.

As far as I know, there are no prior misrepresentation cases where a corporate officer's total compensation was deemed a material matter and the defendant was either criminally charged or imposed administrative monetary penalty. Such being the case, the court's ruling with respect to the materiality issue will be a focal point

of the Nissan case.

Omitted disclosures

Another question, though seemingly not directly relevant to the Nissan case, is whether failure to disclose a material matter that should have been disclosed would constitute a misrepresentation.

The answer to this question appears to differ between the FIEA's provisions regarding administrative monetary penalties and civil liability for misrepresentations in securities filings and its provisions on the crime of filing a false Annual Securities Report. Specifically, the former (FIEA (Article 172-2(2) and Article 21(1)) state that a securities issuer may be imposed administrative monetary penalty or held civilly liable "when a securities filing contains a misrepresentation or omits disclosure of a material matter that should be disclosed;" whereas the latter state that "filers of Securities Reports containing misrepresentations" are subject to criminal penalties.

A minority of commentators interpret the above to mean that if a material matter that should have been disclosed in a securities filing is omitted from the filing, the securities issuer cannot be held criminally liable even if it is imposed administrative monetary penalty or held civilly liable for the omission⁵⁾. In other words, according to this interpretation based on a comparison between the FIEA's criminal and civil liability provisions, criminal penalties do not apply to omissions of material matters that should have been disclosed. The consensus interpretation, by contrast, is that a material omission constitutes a misrepresentation for two reasons. First, a material omission, like an express misrepresentation, could influence securities' market pricing. Second, a material omission can be construed as misrepresentation of a matter that should have been disclosed but was not⁶⁾.

Perpetrator of criminal misrepresentation

The crime of filing a false Annual Securities Report or other disclosure document is committed by the act of filing a document containing a material misrepresentation. The party that commits said act is the party legally obligated to file the document, namely the securities issuer⁷⁾. Criminal misrepresentation is therefore commonly deemed to be a status crime⁸⁾. Under established legal doctrine, "issuer" is expansively construed to include a corporate issuer's representatives, employees and agents⁹⁾.

"Filing" a Securities Report or other disclosure document is not defined as merely

5) Kato, Masaro, ed., *Yuka shoken hokuoshoto no kyogi kisai no horitsu jitsumu* (Legal Practice Pertaining to Misrepresentations in Securities Filings), Nihon Kajo Shuppan (2015), p. 246.

6) Kondo, Mitsuo et al., *Kinyu shohin torihikiho nyumon*, Daiyonhan (Introduction to Financial Instruments and Exchange Act, 4th ed.), Shojihomu (2015), p. 295.

7) Hirano et al., eds., (1996), p. 64; Shimada, Soichiro, *Kyogi kisai yuka shoken hokokusho teishutsuzai to kansanin no kyodoseihansei* (Corporate Auditors' Criminal Complicity in False Securities Report Filings) in *Kinyu shohin torihikiho hanrei hyakusen* (One Hundred Selected Judicial Decisions on Financial Instruments and Exchange Act), Bessatsu Jurisuto (Jurist Special Edition) No. 214 (2013), p. 198.

8) Hirano et al., eds., (1996), p. 68.

9) Kobayashi, Fumiharu, *Kyogi kisai yuka shoken todokedesho teishutsuzaito ni kan suru gaibu keiji sekinin* (Outsiders' Criminal Liability for False Securities Filings), *Tsukuba Hosei* (University of Tsukuba Law and Policy Journal) No. 56 (2013), p. 91.

the mechanical act of transmitting the document. Rather, it refers to the entire process from a disclosure document's drafting by accounting staff through its approval by the the Board of Directors and ultimate delivery to the FSA's regional offices. Accordingly, anyone involved in preparing a presumptively to-be-filed disclosure document containing a misrepresentation is legally a "filer" of the document and could be subject to criminal penalties if the misrepresentation is discovered¹⁰.

¹⁰Hirano et al., eds., (1996), p. 68.

"Discovery" of a misrepresentation means realization that the misrepresentation exists. For example, in the case of falsified financial statements, the realization that some sales that do not meet revenue recognition standards are included in reported revenue would be sufficient to constitute such discovery; ascertainment of the exact amount of the overstatement would not be necessary (per an appellate court decision in the Livedoor case (2008)).

Consequently, in the Nissan case, if the alleged discrepancy between Ghosn's disclosed compensation and actual compensation is ruled a material misrepresentation, Ghosn could be convicted of criminal misrepresentation even if he did not have detailed knowledge of the difference between his actual compensation and the amount disclosed in Nissan's Securities Reports.

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Inquiries to : Financial Market & Innovation Research Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

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