NRI Papers No. 190 November 1, 2013

Regulatory Reform in the Wake of Insider Trading Incidents Related to Public Offerings of New Shares

Sadakazu OSAKI

Nomura Research Institute

NRI Papers No. 190
November 1, 2013

Regulatory Reform in the Wake of Insider Trading Incidents Related to Public Offerings of New Shares

Sadakazu OSAKI

I Revelation of Insider Trading Incidents Involving Capital Increases
II Regulatory Reform Beginning to Develop
III Amendment to the Financial Instruments and Exchange Act
IV Issues Surrounding Insider Trading Regulations

The period from 2009 to 2010 has seen successive, large-scale issues of new shares by Japan's listed companies through public offerings. Under these circumstances, cases frequently occurred where a rapid increase in sell orders such as by short selling before and after the announcement of public offerings led to a sharp drop in the share price, causing the public to talk about suspicions of insider trading related to the public offerings.

Since March 2012, Japan's Securities and Exchange Surveillance Commission (SESC) has disclosed cases of insider trading one after another. The result of such revelations was that this so-called suspicious insider trading has gone beyond mere suspicion and developed into a serious scandal that has shaken market confidence. As preventive measures, the short selling regulations in force were reviewed and consideration was given to an appropriate way of issuing new shares through public offerings.

In June 2013, the Japanese Diet passed a bill to amend the Financial Instruments and Exchange Act. The Amendment Act prohibited the disclosure of inside information and trade recommendations by insiders, etc. The Act also increased the monetary penalty for violations committed by asset managers "on client accounts."

These revisions are expected to contribute to the achievement of some effects in terms of restoring investor confidence in the fairness of the market. However, from the mid- and long-term perspective, more thought should also be given to Japan's formalistic insider trading regulations. In addition, even if new incidents occur in the future, it is vital not to adopt an approach for emphasizing only the aspect of further strengthening regulations.

Copyright 2013 by Nomura Research Institute, Ltd.

I Revelation of Insider Trading Incidents Involving Capital Increases

During the period of 2009 and 2010, the amount of funds raised through public offerings of new shares by Japan's listed companies reached a record high (Table 1). Furthermore, the scale of capital increases has become large. During these two years, the average amount of funds raised by issuing new shares through public offerings was JPY 81.1 billion per case, which substantially surpassed the average amount for the past decade (JPY 14.8 billion).

The factors lying behind such large-scale capital increases include that large companies that were hit by the aggravation of their financial standing because of the economic downturn triggered by the collapse of Lehman Brothers in September 2008 as well as due to the yen's rapid appreciation rushed into capital increases. In addition, because the moves to strengthen regulatory capital adequacy requirements had gained momentum, financial institutions that operate globally were urged to increase their capital holdings.

When listed companies increase their capital holdings on a large scale, the total number of outstanding shares increases, which dilutes the value of existing shares. Therefore, unless investors strongly believe that the funds gained through capital increases will be effectively utilized and such capital increases will lead to increased revenue that can offset or work more than the diluted value, the share price of the listed company issuing new shares will most likely fall. Furthermore, during this period, the world market faced an environment of declining share prices due to factors such as the revelation of sovereign debt crises in European countries such that large-scale capital increases tended to be regarded as bad news. Under these circumstances, situations frequently occurred where sell orders (for stock of a company planning to conduct a public offering of new shares) rapidly increased before and after the announcement of large-scale capital increases, which led to a sharp drop in the share price.

It is not surprising that some investors who regarded the announcement of large-scale capital increases as an unfavorable factor affecting the share price seek to avoid losses by selling their shares; some intend to gain profit by short selling. Furthermore, it would be unrealistic to consider such trading behavior a problem unconditionally. However, if, for example, a certain stock is heavily sold short before the announcement of the issuing of new shares, which leads to a fall in the share price, suspicions of illegal insider trading by persons who obtain nonpublic information on new share issues from a share-issuing company or an underwriter might arise.[2]

Since March 2012, the Securities and Exchange Surveillance Commission (SESC) has disclosed multiple cases of insider trading. The result of such revelations was that this so-called suspicious insider trading related to the issuance of new shares went beyond mere suspicion and developed into a serious scandal.[3] The disclosed cases all involved institutional and other investors who allegedly committed illegal insider trading by obtaining nonpublic information from an underwriter about public offerings of new shares by listed companies (Table 2).

We must admit that, coupled with other scandals including Olympus's concealment of large losses of financial assets and AIJ Investment Advisors' fraudulent asset management, which were revealed during the same period, the series of these insider trading incidents greatly undermined investor confidence in the fairness of Japan's stock market.

Table 1. Trend of capital increases by companies listed on Tokyo Stock Exchange

(Unit: JPY million)

Year	Issues to shareholders		Public offering		Third-party allocation	
	Number of cases	Amount raised	Number of cases	Amount raised	Number of cases	Amount raised
1998	—	—	8	278,181	32	688,016
1999	—	—	28	349,715	75	2,347,286
2000	2	8,240	24	494,149	46	922,756
2001	3	32,047	18	1,201,483	57	477,176
2002	—	—	19	153,312	62	484,350
2003	2	1,451	35	567,236	84	223,161
2004	1	2,729	78	750,232	129	572,627
2005	2	3,721	74	650,847	150	778,055
2006	—	—	69	1,447,724	145	416,476
2007	1	8,086	60	456,974	117	662,102
2008	1	139	27	341,697	93	395,840
2009	—	—	52	4,966,829	115	714,609
2010	1	689	50	3,308,906	88	535,606
2011	—	—	45	967,813	66	395,151
2012	1	414	53	451,766	71	159,327

Note: Since April 2007, the figures include the amounts raised at the time of the initial public offering on the Tokyo Stock Exchange.
Source: Compiled based on material published by the Tokyo Stock Exchange.

Copyright 2013 by Nomura Research Institute, Ltd.

Table 2. Insider trading incidents involving capital increases for which SESC recommended the issuance of orders to pay administrative monetary penalties

Date of SESC recommendation to shareholders	Listed company	Date of announcement of public offering	Offender	Securities firm alleged to have disclosed information	Profit gained by fund	Monetary penalty
March 21, 2012	INPEX Corporation	July 8, 2010	Chuo Mitsui Asset Trust and Banking Company, Limited	Nomura Securities Co., Ltd.	JPY 14.55 million	JPY 50,000
May 29, 2012	Nippon Sheet Glass Co., Ltd.	August 24, 2010	Asuka Asset Management Co., Ltd.	J.P. Morgan Securities Japan Co., Ltd.	JPY 60.51 million	JPY 130,000
May 29, 2012	Mizuho Financial Group, Inc.	June 25, 2010	Chuo Mitsui Asset Trust and Banking Company, Limited	Nomura Securities Co., Ltd.	JPY 20.23 million	JPY 80,000
June 8, 2012	Tokyo Electric Power Company, Inc.	September 29, 2010	First New York Securities LLC and specific individuals	Nomura Securities Co., Ltd.	—	JPY 14.68 million JPY 60,000
June 29, 2012	Nippon Sheet Glass Co., Ltd.	August 24, 2010	Japan Advisory Ltd.	Daiwa Securities Co., Ltd.	JPY 16.24 million	JPY 370,000
November 2, 2012	Elpida Memory, Inc.	July 11, 2011	Japan Advisory Ltd.	Nomura Securities Co., Ltd.	JPY 5.64 million	JPY 120,000

Source: Compiled based on material published by the Financial Services Agency.

II Regulatory Reform Beginning to Develop

1 Review of short selling regulations

Even at the stage where the issue of insider trading involving equity issuance was still considered as mere “suspicion,” inadequate market regulations have been pointed out as one of the background factors that gave rise to such suspicion. Faced with this situation, the regulator first set out to review the regulations governing short selling in anticipation of public offerings of new shares.

The offer price of new shares when a company intends to increase its capital through a public offering is generally set at a level lower than the market price. The reason for this is that if the market price is lower than the offer price, it is hard to assume that any investors will be willing to purchase new shares in response to the public offering.

Short selling itself is a legitimate economic activity. However, if certain stocks are sold short, in particular, heavily and intensively, such activity generates pressure to drop share prices. Thus, the situation in which a person undertakes a short sale after the announcement of new share issuance through a public offering and makes settlement for such short selling using shares acquired through the public offering at a price below the market price is analogous to the situation where a person who pushed down the share price himself/herself reaps a profit generated from such drop in the share price. Other market participants are most likely to have the feeling of unfairness for such activity. Moreover, if such activity is permitted, the formation of the share price after the announcement of equity issuance through a public offering would be destabilized, presenting the possibility of hindering smooth fund procurement by listed companies.

In light of this aspect, in the U.S., as part of Regulation M under the U.S. Securities Exchange Act, which was adopted by the U.S. Securities and Exchange Commission (SEC), Rule 105 prohibits buying new shares through a public offering if the buyer has undertaken short selling within the restricted period (the period beginning five business days before the pricing of the offered shares and ending with such pricing).

In Japan, modeled on this rule, the August 2011 amendment to the cabinet order prohibits the activity of making settlement using the shares acquired through a public offering to cover a short position taken after the announcement of capital increases through the public offering (Article 26-6 of the Order for Enforcement of the Financial Instruments and Exchange Act). This regulation went into effect in December 2011 and has demonstrated the effect of restraining short selling after the announcement of capital increases through a public offering at least to some extent.

2 Review of insider trading regulations

In relation to the resolution of a string of incidents, criticism was raised over the fact that the monetary penalty imposed on institutional and individual investors who committed insider trading was a small sum of a few multiples of ten thousand yen depending on the case. This criticism was raised on the grounds that the monetary penalty that can be easily paid even from the pocket money of individuals cannot be expected to act as a deterrent to restrain institutional investors managing large amounts of assets from committing unlawful acts.

Copyright 2013 by Nomura Research Institute, Ltd.

Moreover, even though it was pointed out that the employees of a securities firm that does have responsibility for maintaining the fairness of the market were involved in the leak of inside information (material nonpublic facts), the relevant securities firm was not subject to penalties such as fines, about which not a few people had a feeling of wrongdoing.

Regarding these issues, discussions touched on the comparison of insider trading regulations with those of other countries. It was pointed out that in the U.S. and European countries, higher monetary penalties are likely to be imposed and a person who disclosed inside information is also likely to be subject to penalties such as fines. These discussions went on to raise the question that Japan's insider trading regulations might be too weak as compared to those in the U.S. and Europe.

To address these issues, since July 2012, the Working Group on Insider Trading Regulations (chaired by Professor Hideki Kanda, Graduate Schools for Law and Politics, The University of Tokyo), which was established by the Financial System Council, reviewed the regulations with focus placed on the following two points and compiled a report in December 2012.[4]

(1) Strengthening the regulations on the disclosure of inside information and trade recommendations based on such information
(2) Reviewing the monetary penalty regime for violations committed by asset managers "on client accounts"

In April 2013, a bill to amend the Financial Instruments and Exchange Act created based on the recommendations made in this report was submitted to the Diet. This amendment is discussed in detail in Chapter III.

3 Considerations related to capital increases through public offerings

Insider trading incidents involving the issuance of new shares have been observed as serious scandals rocking Japan's financial markets. Such observation was made because these incidents unveiled the structural issues facing Japan's primary stock market, rather than because of the mere exposure of the lack of professional ethics on the part of specific institutional investors and securities firms.

Actually, in light of a wide variety of data collected through research, some experts pointed out that the incidents that were revealed only constituted the tip of the iceberg.[5] Furthermore, the Financial Services Agency was aware of some institutional investors strengthening their influence over securities firms and demanding that they provide them with "useful information." As such, it would be natural that voices have been increasingly raised that call for taking actions to address the structural issues involving large-scale capital increases through the public offerings that constituted the background factors of the incidents.

In December 2012, the Japan Securities Dealers' Association, which is a self-regulatory organization of securities firms, established the Subcommittee on the Revitalization of the Japanese Economy and Appropriate Ways of Capital Increases through Public Offerings. The subcommittee conducted research on the actual status of capital increases through public offerings by listed companies and regulations on such activities, as well as on international comparisons of these matters. At the same time, the subcommittee started discussing the measures that could be adopted on the part of securities firms.

While the subcommittee gave other thoughts to the functions served by the past regulations that permitted raising capital through public offerings only for listed companies that were generating more than a certain level of profit, the subcommittee did not adopt an approach to introducing regulations that uniformly restrict raising capital by listed companies. In March 2013, based on subcommittee discussions, a code of conduct relating to the underwriting of new share issuances through public offerings by member firms was created. In June, a report outlining the issues to be addressed in the future was announced.

III Amendment to the Financial Instruments and Exchange Act

This chapter explains the specific content of the amendment to the Financial Instruments and Exchange Act (FIEA), which was described in Chapter II. The bill for the amendment passed the Diet on June 12, 2013. In the future, revisions will be made to the relevant cabinet order and cabinet office ordinance under the FIEA. The date of the enforcement of the amendment act is the date specified by a cabinet order within a period not exceeding one year from the day of promulgation.

1 Prohibition of inside information disclosure

Insider trading prohibited by the FIEA is any transaction conducted by corporate insiders (referring to an officer or an employee of a listed company, its legal advisor, an officer or an employee of a lead underwriter (a securities firm)) or TOB insiders (referring to persons concerned with tender offeror, etc.), who have knowledge of inside information, before the announcement of the listed company's public offering. (Corporate insiders and TOB insiders are referred to as "insiders, etc." in this paper.) In addition, transactions conducted by a person who received inside information directly from insiders, etc. are

Copyright 2013 by Nomura Research Institute, Ltd.

also subject to the regulations (Articles 166 and 167 of the FIEA).

However, in the past, simply disclosing inside information was not subject to criminal sanctions or monetary penalties unless the person who disclosed inside information induced trading based on the disclosed information or shared in the gained profit with knowledge of the transaction conducted based on the disclosed information, in which case, there was a possibility of being punished as an accomplice.

However, in European countries, Directive 2003/6/EC of the European Union on insider dealing and market manipulation (market abuse) requires member states to prohibit the act itself of disclosing inside information to a third party unless such disclosure is made in the normal course of the exercise of business or duties. In addition, it prohibits a securities firm, etc. from recommending or inducing another person, based on inside information, to acquire or dispose of financial instruments to which that information relates. In the U.S., the person who discloses information could also be punished as an accomplice of insider trading. In addition, Regulation Fair Disclosure (FD), adopted by the U.S. Securities and Exchange Commission (SEC), prohibits selective disclosure of inside information by a listed company or its executive officers to securities market professionals, such as stock analysts of securities firms and fund managers of institutional investors.

In this respect, the 2013 Amendment Act prohibits the disclosure of inside information and recommendation of a trade based on such information for the purpose of enabling a recipient to gain profit or avoid loss before insiders, etc. make the relevant inside information public (Article 167-2 of the FIEA). Punitive provisions are also added. Specifically, an offender under this regulation is subject to imprisonment with labor for not more than five years, a fine of not more than JPY 5 million or to both only when the insider trading was conducted by the person who received information or was advised to conduct a trade (Items 14 and 15, Article 197-2 of the FIEA). Furthermore, a monetary penalty amounting to 50 percent of an amount equivalent to the profit gained by the information recipient is imposed (Item 3, Paragraph 1 and Item 3, Paragraph 2, Article 175-2 of the FIEA).

The Amendment Act stipulates a subjective requirement, which is disclosing information “for the purpose of enabling a recipient to gain profit or avoid loss,” as one of the essential elements constituting an illegal act, as well as the trading requirement, referring to the fact that insider trading has actually occurred, as a condition for punishment. This is because if the regulation on the disclosure of inside information is applied too extensively, the regulation might impede normal business activities, and the range subject to punishment might be unduly expanded. For example, suppose that an executive officer of a listed company discloses inside information concerning M&A (a company’s acquisition and merger) in which the relevant listed company is involved to a press reporter, or that the executive officer talks about the M&A moves when explaining the reasons why he comes back home late every night to his family. While the possibility that such a disclosure might conflict with internal rules cannot be precluded, it is not reasonable to assume that such disclosure should be subject to punishment.

With respect to the subjective requirement, at the meetings of the Working Group on Insider Trading Regulation of the Financial System Council, some members expressed concern over the idea that “if the subjective requirement is included, it might become difficult to prove violation without a confession of the person accused of disclosing inside information.” However, for cases such as those in which market professionals are involved, which have been seen in a series of recent insider trading incidents involving capital increases through public offerings that triggered the start of deliberations on ways to review insider trading regulations, it appears not so difficult to prove the probability that “there was intention to recommend a trade” based on observable facts. It would be a groundless fear that the inclusion of the subjective requirement would create loopholes in the regulation.

Furthermore, during deliberations at the Working Group meetings, some members pointed out that violations by intermediaries such as securities firms that should be responsible for ensuring fairness in the markets significantly undermine investor confidence, such that these violations should be subject to regulation even if a trade does not actually occur. In this regard, the existing business regulations imposed on securities firms already prohibit the recommendation of a trade by providing confidential corporate information including inside information. In light of this fact, the Working Group ultimately recommended that consideration should be given to the amount of trading commissions continually paid by institutional investors to securities firms based on their periodical broker rating reviews. The basis for this recommendation is the fact that intermediaries such as securities firms generally have a wide range of profit sources (trading commissions, underwriting commissions, etc.). The Working Group also recommended that deterrence measures should be taken such as publishing the name of an officer or employee who actually disclosed information and recommended a trade.

In response to these recommendations by the Working Group, the 2013 Amendment Act includes provisions requiring a securities firm to pay an amount equivalent to the monthly brokerage fee that is paid by a recipient of information for three months and 50 percent of the underwriting commission as a monetary penalty for a violation committed in relation to stock brokerage and public offerings of new shares (Items 1 and 2, Paragraph 1, Items 1 and 2, Paragraph 2 of the FIEA).

Copyright 2013 by Nomura Research Institute, Ltd.

2 Reviewing the monetary penalty regime for violations committed by asset managers "on client accounts"

Establishment of the current monetary penalty regime under the FIEA was based on the fundamental concept of forfeiting the economic gains obtained by an offender in committing an illegal act in order to ensure the practical effect of the regulations. The reason the monetary penalties imposed on institutional investors, etc. in relation to a string of insider trading incidents were small is that in the case of institutional investors, etc., which are entrusted to manage assets by their clients, the calculation of the fine is based on the asset management fees that are considered to be directly derived from the illegal trade rather than the overall profit acquired through the illegal trade.[6]

One way of looking at this issue would be that if the nature of the monetary penalty, which is part of administrative sanctions, is considered, there is not necessarily a need to stand by the idea of forfeiting the gains acquired by an offender. Another way of looking at this issue would be that excessively emphasizing the punitive nature of a monetary penalty would conflict with Article 39 of the Constitution of Japan, which prohibits placing anyone in double jeopardy.

The report of the Working Group that deliberated on the amendment to the FIEA concluded that the methods of calculating monetary penalties should be revised based on the conventional concept for the time being, provided that how the monetary penalty regime should be is an "issue that should be addressed in the future." Specifically, one of the background factors behind institutional investors, etc. committing violations is their aim to continuously maintain and increase management fees in the future. From this perspective, the Working Group recommended that without confining the idea to individual illegal trades (this concept is adopted in the current regulations), the monetary penalty should be calculated based on the management fees paid during a certain period (for example, for three months).

In response to this recommendation, the 2013 Amendment Act defines the monetary penalty for committing insider trading in the course of managing assets on client accounts as the monthly management fee for three months. At the same time, similar provisions are applied to other unfair trade practices such as circulating a rumor (Item 3, Paragraph 1, Article 175 of the FIEA and other provisions).

3 Other revisions

The 2013 Amendment Act also includes important provisions that are not directly related to insider trading incidents involving capital increases through public offerings.

First, a company subject to a tender offer (an offeree company), its officers and employees are included in the "TOB insiders" under the insider trading regulations (Item 5, Paragraph 1, Article 167 of the FIEA). In Japan, most tender offers are non-hostile and are conducted with prior agreement between offeror and offeree companies. In light of this situation, the amendment is designed to eliminate irrationality caused by the fact that a person who received inside information from an offeree company, its officer or employee is exempt from the regulations as a secondary recipient of information.

Second, it has become possible for a recipient of nonpublic tender offer facts to purchase shares of the offeree company in the following cases: where the recipient who intends to buy the shares submits a tender offer notification in which nonpublic tender offer facts disclosed to the recipient is described for public viewing and where six months have passed since the disclosure of the information (Items 8 and 9, Paragraph 5, Article 167 of the FIEA). This amendment addresses the current regulatory issue in which, if nonpublic information is intentionally disclosed to a person who is likely to conduct competing purchases, it becomes difficult to make purchases to counter such competing purchases.

Third, the scope subject to the exemption of the insider trading regulations in relation to negotiated transactions conducted off the market between specific persons who possess inside information is expanded to include transactions conducted between a primary recipient (a person who received inside information directly from insiders, etc.) and a secondary recipient (a person who received information from a primary recipient) (Item 7, Paragraph 6, Article 166 of the FIEA).

Fourth, the Japanese Real Estate Investment Trust (J-REIT) to which the insider trading regulations have not been applied in the past is now subject to such regulations (Item 2-2, Paragraph 1, Article 166 and other provisions of the FIEA). In the past, it was thought that there is little likelihood of insider trading involving J-REIT because the formation of prices is based on the net asset value of the assets under management. However, looking at the actual trend of prices, major changes are occurring, for example, due to a change of a sponsor company. As such, the revision was made on the grounds of the possibility that a person who is in a position to access inside information might conduct a trade that undermines market confidence.

Here, the legislation reflected the characteristics of J-REIT stock that are different from those of ordinary stocks. Specifically, the material facts include facts related to asset management companies in addition to J-REIT itself. Furthermore, a sponsor company that controls an asset management company, its officers and employees are included in the definition of corporate insiders, etc.

In addition to the above four matters, the report of the Working Group that deliberated the revisions also recommended the establishment of more comprehensive

Copyright 2013 by Nomura Research Institute, Ltd.

provisions for regulatory exemption in relation to trades based on contracts concluded and plans adopted before becoming aware of inside information. The report also suggested providing interpretations of laws and regulations in advance by means of guidelines as necessary. In this respect, while the revision was not made to the current regulations (Item 12, Paragraph 6, Article 166 of the FIEA), the provisions of the Cabinet Office Ordinance stipulating these details are to be revised.

The report also recommended the following measures to create a market environment that prevents the occurrence of unfair trades such as insider trading.

(1) The Financial Services Agency (FSA) and the Securities and Exchange Surveillance Commission (SESC) should compile past insider trading incidents in a way that these past incidents can serve as a reference for conducting actual business activities.
(2) Securities companies and self-regulatory organizations should strengthen their internal controls over compliance and review sales practices.
(3) The stock exchanges should provide warnings to a listed company where a person who improperly disclosed inside information works. The stock exchanges should also consider a way of disclosing more in-depth information in the event a scoop has been reported on material facts pertaining to a listed company.

The respective responsible organizations are expected to take up these recommended measures in addition to the revised regulations.

IV Issues Surrounding Insider Trading Regulations

1 Problems of a formalistic approach

The revisions to the insider trading regulations that are explained in Chapter III are expected to contribute to the prevention of unfair trades as well as to the improvement of investor confidence in the fairness of the market. However, at the same time, it should not be overlooked that Japan's insider trading regulations have inherent problems that can be expressed as structural issues, which should be addressed from the mid- and long-term perspective.

As stipulated by the provisions of Articles 166 and 167 of the FIEA, Japan's insider trading regulations define concepts such as "insiders, etc. who are subject to the regulations," "information recipients," "material facts" and "publication" in an extremely technical and detailed manner. This regulatory method can be considered as being based on formalism. In contrast, the U.S. and EU adopt a substantialistic approach whereby the essential elements constituting insider trading are defined in an abstract manner.[7]

It is said that the reason behind the adoption of a formalistic approach by the Japanese law is that because the insider trading regulations impose criminal sanctions for violations, the essential elements constituting a crime must be strictly defined under the principle of legality (no punishment without law). However, under such regulations, there is a risk that a trade that is unlikely to undermine confidence in market fairness from a commonsense standpoint might be regarded as a violation of law in terms of formality. This is a problem of the so-called "accidental insider trading." A typical case of this accidental trading is the case of Komatsu. In March 2007, the Financial Services Agency (FSA) ordered Komatsu to pay a civil fine on the grounds of insider trading. After dissolving its subsidiary that was virtually in a dormant state, Komatsu repurchased its shares before making such dissolution public. This action was regarded as insider trading.

Some officials stated that while cases that can be regarded as the absence of compliance in which a chief executive officer/president of a company who freely trades its own shares without making efforts for information management would apparently be accused of violating insider trading regulations, currently, the Securities and Exchange Surveillance Commission does not reveal such accidental insider trading because the revelation of such cases would wither the market considerably.[8] However, it is too early to say that such a way of implementing the law is officially institutionalized. Therefore, listed companies, etc. and investors still face a non-ignorable risk of being accused of "accidental" insider trading.

On the other hand, the definition that "material facts under insider trading regulations refer to those that have a great impact on share prices if such facts are made public," the adoption of which can be regarded as a regulatory shift to substantialism, meets with strong resistance mainly in the economic world for the reason that such definition would reduce predictability and make compliance difficult.[9]

When insider trading regulations were introduced in 1988, insider trading was considered to be a "technical offense," such that the maximum penalty was light and set to imprisonment with labor for not more than six months. However, currently, the recognition that insider trading is a serious crime that undermines market confidence has become common, and the maximum penalty was increased to imprisonment for not more than five years, which is ten times what it was about 20 years ago. The 2013 Amendment Act expanded the scope of punishment by imposing regulations on the improper disclosure of inside information and trade recommendations. In light of this expansion, the author believes that the need will increase to turn in the direction towards strictly regulating only more substantial violations.[10]

Copyright 2013 by Nomura Research Institute, Ltd.

2 Need for responses that face up to reality

A string of insider trading incidents related to capital increases through public offerings in which securities companies that do have responsibility for ensuring the fairness in the market have been alleged to be involved in unfair trades has shaken the confidence of the public, and voices calling for thorough preventive measures have been increasing. In addition to the amendment to the FIEA, securities companies, institutional investors, etc. are obviously urged to strengthen their internal controls over compliance.

On the other hand, no matter how many regulations are put in place, no matter to what degree penalties and surveillance are strengthened, and no matter how strictly internal controls over compliance are ensured, the reality is that it is impossible to eliminate insider trading completely. The author believes that by facing up to this reality, it is also important to take a more calm view in dealing with the situation. Whenever a typical insider trading is committed, it is possible to gain a lot as a magnet gathers iron filings. Greed is one of the fundamental human desires. In the same way as thefts and burglary do not disappear, insider trading will never vanish as long as securities markets exist.

For example, in the U.S., the criminal sanction against insider trading is heavy, with the maximum sentence being 20 years' imprisonment. The U.S. Securities and Exchange Commission (SEC), which is equipped with a greater number of personnel and a larger budget than Japan's authorities, discloses 40 to 50 insider trading cases every year. Nevertheless, such revelations have not yet been able to lead to the eradication of insider trading.

The author hopes that the readers will not misunderstand what is mentioned above. The author is not at all saying that imposing regulations on and exercising control over insider trading is useless. Rather, the author believes that effectively revealing accusable cases and inflicting strict punishment on such cases is the only method of maintaining market fairness and ensuring investor confidence.

What the author is concerned about is, first, that excessive expectations might be placed on the effects of "preventive measures," which leads to thoughts that do not face up to reality by saying that "because preventive measures have been taken, unlawful trades must have been eliminated."[11] Another concern is that when unfair trades occur again in the future, attracting a great deal of public attention, the focus of discussions might only be placed in the direction towards further expanding the scope subject to regulations and making punitive provisions heavier.

Currently, many companies and organizations still restrict stock trading by their officers and employees for the reason of preventing the occurrence of insider trading and uniformly obligate them to provide prior notification of stock trading and to hold shares for more than a certain period. These rules are not necessarily realistic. At the same time, it is also true that some people are involved in unlawful insider trading as if they think nothing of violating such rules. If only the aspect of further strengthening regulations is emphasized in the future, such stricter regulations might impede lawful information exchanges and stock trading, ushering in the arrival of a society where law-abiding citizens steer clear of stock investment as it is proverbially said that "a wise man never courts danger." The author cannot help but have concern over the arrival of such a society.

Notes:

1 This paper is based on the following article written by the author, to which substantial additions and modifications were made, such as by including the content of the Amendment Act, which was promulgated after publishing this article: "Insider torihiki kisei minaoshi no gaiyou to kongo no kadai (Outline of the review of insider trading regulations and future issues)," *Gekkan Shihon Shijo*, March 2013.

2 Because there are cases in which shares are sold short by considering that a specific listed company is likely to issue new shares through a public offering in the near future, as determined by factors such as the listed company's chief executive officer/president's talk and conduct, a demand-supply situation of the stock loan market, and by observing the trends of competitors, as well as those in which shares are sold short by looking at an increase in sell orders, it is not appropriate to unilaterally decide that all cases of short selling before the announcement of capital increases are illegal insider trading.

3 The news article that first reported these suspicions was the Financial Times, FT.com, October 28, 2010, "Tokyo hit by claims of insider trading" by Michiyo Nakamoto and Lindsay Whipp.

4 "The Review of Insider Trading Regulation Following Recent Violations and Other Development," http://www.fsa.go.jp/en/refer/councils/singie_kinyu-reports-20121225-02.pdf

5 Masahito Kato and Katsushi Suzuki, "Zoshi insider mondai to shikin chotatsu cost (Issue of insiders related to capital increases and fund procurement cost)," *Securities Analysts Journal*, Vol. 51, No. 1, 2013, The Securities Analysts Association of Japan.

6 According to Paragraph 1, Article 1-21 of the Cabinet Office Ordinance on Administrative Monetary Penalty pursuant to Chapter VI-2 of the Financial Instruments and Exchange Act, the calculation formula for monetary penalty is as follows: (the total sum of monetary or other property value that was paid or should be paid in compensation for the management of the relevant assets to a person who conducted the relevant trade for the month in which the relevant trade was conducted in the course of managing assets under management (which refers to management fees for one month)) × (the maximum value of the relevant traded stocks that are the relevant assets

Copyright 2013 by Nomura Research Institute, Ltd.

under management during the period between the day on which the relevant trade was conducted and the end of the month in which the relevant trade was conducted) / (the total sum of the relevant assets under management at the end of the month in which the relevant trade was conducted).

7 Naohiko Matsuo, *Kinyu shohin torihiki ho* (Financial Instruments and Exchange Act), 2nd Edition, Shojihomu, 2013.

8 Yasuhito Omori, "Insider kisei to no tsukiai kata (How to deal with insider regulations)," *Kinzai Weekly Financial Affairs*, Vol. 63, No. 40, 2012, Kinzai.

9 Rather, the situation is more pronounced in which some voices are calling for the repeal of the basket clause (Items 4 and 8, Paragraph 2, Article 166 of the Financial Instruments and Exchange Act) that provides the definition of material facts.

10 The following paper had advocated a shift to substantialistic regulations even before the start of discussions on the recent revisions: Yoshimasa Umemoto, "insider torihiki kisei no saikochiku (Reconstructing insider trading regulations)," *Kigyoho no kadai to tenbo* (Issues and prospects of company law) published in commemoration of the sixtieth birthday of Professor Shigeru Morimoto and edited by Noboru Kawahama, Masahiro Maeda, Hiroshi Suzaki and Masashi Kitamura, 2009, Shojihomu.

11 "Gyosei shobun (Administrative penalty)," (*Kinyu homu jijyo* (Financial Law Journal), Vol. 60, No. 14, 2012, Kinzai), which was written by Yasuhito Omori, reported the case in which a securities company that was involved in insider trading related to capital increases in the past made strenuous efforts to establish an internal system to prevent the recurrence of such incidents by learning a lesson from the incident in which its employee was involved. The paper went on to point out the prejudiced impression caused by the idea that "because we made such a great deal of our efforts to prevent recurrence, inside information must not have leaked from our company."

Sadakazu OSAKI is head of research at NRI's Center for Strategic Management & Innovation. His specialties include securities market theory and capital market law.

Copyright 2013 by Nomura Research Institute, Ltd.

As a leading think tank and system integrator in Japan, Nomura Research Institute is opening new perspectives for the social paradigm by creating intellectual property for the benefit of all industries. NRI's services cover both public and private sectors around the world through knowledge creation and integration in the three creative spheres: "Research and Consulting," "Knowledge Solutions" and "Systems Solutions."

The world economy is facing thorough structural changes led by the dramatic growth of IT industries and the rapid expansion of worldwide Internet usage—the challenges of which require new concepts and improvement of current systems. NRI devotes all its efforts to equipping its clients with business strategies for success by providing the best in knowledge resources and solutions.

NRI Papers present selected works of NRI Group's 7,000 professionals through its worldwide research network. The mission of ***NRI Papers*** is to contribute new ideas and insights into business management and future policy planning, which are indispensable for overcoming obstacles to the structural changes in our society.

All copyrights to ***NRI Papers*** are reserved by NRI. No part of this publication may be reproduced in any form without the prior written consent of NRI.

Inquiries to: Corporate Communications Department
Nomura Research Institute, Ltd.
E-mail: nri-papers@nri.co.jp