

**Client Alert: The FSA of Japan is soliciting comments on the proposed revision of the short-selling regulations****1. Summary**

The FSA of Japan published a letter titled "Re: Comprehensive revision of short-selling regulations" on March 7, 2013 (the "Letter"), and is soliciting public comments.<sup>1</sup> The deadline for public comments is April 8, 2013.<sup>2</sup> The revisions after the public comment procedure will be implemented in November 2013.

The Letter proposes overall changes in short-selling regulations that include deregulation whereby price restrictions will be applied only in limited circumstances, but mostly consist of revisions designed to tighten restrictions and expand the applicability of the short-selling regulations.

To cope with these changes, among other things, market participants would need to make system changes to comply with the revised reporting requirements, revised price restrictions and other revisions, and to reevaluate their current policies and practices.

Below we outline the proposed revisions contained in the Letter.

**2. Expansion of the applicability of short-selling regulations**

"Short sales" are defined under the current Japanese short-selling regulations to mean one of the following activities conducted on a Japanese stock exchange:

- (1) sales of securities without physically holding the securities at the time of the agreement to sell;
- (2) sales of securities which the seller has borrowed or expects to borrow; and
- (3) sales of securities in circumstances where delivery of such securities at settlement is not assured or certain at the time of the placement of the order.

It is not clear whether the Letter proposes to expand this definition of short sale. However, to cover short sales in a Proprietary Trading System ("PTS")<sup>3</sup> where an order is executed via auction, with a market making broker or against matching limit orders, it proposes expanding the applicability of the following restrictions:

- (1) price restrictions;
- (2) prohibition of naked short sale;
- (3) requirement to differentiate between "short sale" and "long sale" when placing orders; and
- (4) prohibition of making settlement with the borrowed securities for short sale using the securities acquired through a public offering.

**3. Triggering up-tick rule only in limited circumstances**

Under the current rule, with certain exemptions, any short sale of securities must always be effected subject to an up-tick rule, at a price higher than the latest price announced by a stock exchange (or such other price as provided in the relevant rules).

The Letter proposes to add a "trigger" feature, whereby the up-tick rule would be applicable only if the price of the securities falls by more than 10% from its closing price on the previous day. Once the up-tick rule is triggered, the price restriction remains in effect until the closing on the following day.

**4. Making the prohibition of naked short selling permanent**

Under the current rule, a short seller must make either of the following "cover" arrangements, and provide his broker with sufficient information for the broker to ascertain that the short sale is a "covered short sale":

- (1) the short seller has entered into a securities lending transaction at the time of the placement of the order, where the lender is obligated to deliver the borrowed securities to the short seller by the settlement date of the short sale (typically the standard three-day settlement period for trades on a Japanese exchange); or
- (2) the short seller has taken "equivalent measures"

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to ensure that the securities will be delivered on time.

While this prohibition of naked short sales is currently a temporary measure effective only within a specified period of time, the expiration date of the effective period has been extended over several years. The Letter proposes to make this prohibition permanent.

## 5. Tightening the reporting requirements

Under the current rules, any person who enters into a short sale of a Japanese listed security must report the short sale position, if (i) its short sale position amounts to 0.25% or more of such listed securities that are issued and outstanding, and (ii) the short sale position amounts to more than 50 board lots on the relevant Japanese stock exchange. The reporting is made through the executing broker/dealer to the relevant stock exchange, and the stock exchange discloses the information submitted by short sellers on its website.

The Letter proposes introduction of a “two-tier model” which features two thresholds that trigger the reporting and disclosure requirements at different levels. Under the two-tier model, (i) a short sale position amounting to 0.2% will trigger the reporting requirement, and (ii) 0.5% will trigger the disclosure requirement. The Letter also proposes a new rule to ease the requirement of a report and disclosure on a change in the short position. Under the new reporting rule, (i) changes of 0.1% or more in a short sale position will trigger the reporting requirement, and (ii) changes in a short sale position that bring the short sale position to below a 0.2% or 0.5% threshold level will trigger the reporting or disclosure requirement, respectively. The Letter also proposes the revision of the reporting procedures and information to be reported and disclosed.

While the reporting and disclosure requirements are currently a temporary measure, the Letter proposes making them permanent.

## 6. Revision of exempted transactions

The exempted transactions of certain short selling restrictions are currently enumerated in the Cabinet Order. The Letter proposes necessary revisions in light of (i) harmonizing the proposed revisions (e.g. creation of a new exemption applicable to arbitrage trade between an exchange and PTS), (ii) application of exemptions to new types of financial instruments listed on exchanges, and (iii) responding to the need to restrict the transactions circumventing the regulations (e.g. prohibition of placement of a proprietary “long”

sale order by a broker that, in real terms, is execution of a customer’s short sale order).

<sup>1</sup> Available at: <http://www.fsa.go.jp/news/24/syouken/20130307-1.html> (Japanese only). The FSA is also soliciting public comments on their proposal concerning the purchase of own shares by the issuer company. The FSA has proposed that the current temporary measures to ease the cap on the maximum purchase amount and the entire ban on trading within the last 30 minutes before the closing be maintained as permanent measures.

<sup>2</sup> We plan to send to the FSA our comments on the proposed revisions. If you have comments on the Letter, please feel free to provide us with those comments. We will take into account your comments when we send our consolidated comments to the FSA.

<sup>3</sup> A PTS is an electronic trading system operated by a broker with a special FSA license. It is similar to an Alternative Trading System in the U.S. markets.