Issues Related to Provision of Claims for Short-Term Trading Profits

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[Abstract]
Article 164, Paragraph 1 of the Financial Instruments and Exchange Act (hereinafter referred to as "this Article" of "FIEA") stipulates that "in order to prevent officers or major shareholders of listed companies from improperly using secrets obtained through their duties or positions, if such persons make a purchase of specific securities of the listed company on their own account and then sell within six months, or sell and then purchase within six months and make a profit, the listed company may claim that the profit be provided to the listed company." A major shareholder is defined in Article 163, Paragraph 1 of the Financial Instruments and Exchange Act as a shareholder who holds 10% or more of the voting shares.

This Article was introduced in 1948, when Japan was under U.S. occupation, as a provision to protect investors in the name of democratizing securities, by adopting the U.S. Securities Exchange Act Section 16(b) ("Short-Swing Profit Rule") almost as it is. However, in the U.S., at the time of the enactment of Section 16(b) of the Securities Exchange Act in 1934, there were many cases where company officers improperly profited by using inside information, and shareholders often filed claims for damages as fraudulent acts contrary to fiduciary relationships. In contrast, in Japan, such issues were not problematized manifestly, and despite the lack of legislative facts, this provision was unilaterally and somewhat forcibly adopted due to considerations of occupation policy, without sufficient theoretical examination.

Regarding this Article, there are many issues, such as: (i) it constitutes a dual regulation with the insider trading regulations (Articles 166 and 167 of the FIEA) that aim to prevent improper acts by officers or major shareholders (hereinafter referred to as "officers, etc.") and to ensure investor confidence in the fairness and soundness of the market, (ii) the issuing company does not suffer any damage and there is no basis for receiving the return of the profit, and (iii) even if a person related to the issuing company proves that there is no causal relationship between the inside information they obtained and the short-term trading profit, they are not exempt from the obligation to provide the profit. Therefore, this Article should be abolished in future legislative discussions.

I. Legislative History of This Article (Article 164, Paragraph 1 of the FIEA)

This Article was introduced during the amendment of the Securities and Exchange Act in 1948 (Article 189). It was almost entirely adopted from Section 16(b) of the U.S. Securities Exchange Act of 1934 (still in existence). However, in the U.S., at the time of the enactment of this Article, there were many cases

where company officers improperly profited by using inside information to trade their own company's stock, and shareholders filed claims for damages against officers on the grounds that it was a fraudulent act contrary to the fiduciary relationship with shareholders. This was legislatively resolved to address parts that could not be remedied under Common Law principles (such as the difficulty of establishing bad faith or scienter to prove a breach of fiduciary duty or a fraudulent act on the part of an officer). However, there have been criticisms from the beginning for the following reasons, and at one point, the U.S. Congress considered abolishing it:

(1) It does not address the insider's intent to defraud or to profit on inside information, does not question whether insider information was held, and does not prohibit short-term trading itself, making it ineffective in achieving the goal of preventing insider trading. It also covers only a limited subset of transactions. For example, it does not impose a penalty for "tipping" inside information or for trading based on tipped information, does not cover an individual purchase or sale based on inside information or a series of purchases or sales if such purchase(s) or sale(s) are not accompanied by an opposite-way transaction within the six-month short-swing period.

(2) Since "short-term trading" is limited to transactions within six months, intentional evasion is possible, such as trading six months and one day later.

(3) Since the profit is considered the difference between the highest selling price and the lowest purchase price within six months, officers, etc., may be required to return more than the actual profit they obtained.

(4) It does not allow for regulatory enforcement but instead relies on stockholder lawsuits, which are largely driven by an active plaintiff's bar motivated by attorney's fees rather than actual harm to companies and their stockholders.

In Japan, on the other hand, at the time of the enactment of this Article in 1948, there were no apparent issues of company officers improperly profiting from trading their own company's stock using inside information, at least on the surface. However, this was only because it did not surface, and in reality, it was common for people to obtain inside information earlier than others and profit quickly. The reason it did not surface was that Article 189 (the provision for claims for the provision of short-term trading profits) and its prerequisite Article 188 (the obligation to report stock holdings by officers or major shareholders) were extremely inadequate, lacking provisions for public disclosure as in U.S. law. In this context, Article 188, the prerequisite for Article 189, was abolished in 1953 due to its lack of effectiveness. Since the enactment of Article 189 in 1948, there have been almost no cases of claims for the provision of short-term trading profits for over twenty years.

With the amendment of the Securities and Exchange Act in 1988, insider trading was prohibited with penalties, and Article 188 was revived, with additional provisions for handling after the submission of reports and delegation of exemption clauses to Cabinet Office ordinances, and Article 189 (currently Article 164 of the Financial Instruments and Exchange Act) was improved. However, with the introduction of the prohibition of insider trading in 1988, it can be said that the mission of the provision for claims for the

provision of short-term trading profits was completed, and the position of the system for claims for the provision of short-term trading profits should be discussed, including the revision or abolition of the system.

II. Purpose and Means of This Article (Article 164, Paragraph 1 of the FIEA)

The purpose of this Article, as clearly stated in the text, is "to prevent officers or major shareholders of listed companies, etc., from improperly using secrets obtained through their duties or positions." Specifically, it aims to prevent improper acts by officers, etc. (officers and major shareholders) and to ensure investor confidence in the fairness and soundness of the market, given that officers, etc., and general investors are in qualitatively different positions, with the latter being overwhelmingly disadvantaged in terms of information. The means to achieve this purpose is to allow listed companies to claim that officers to provide the profit to the listed company, if they make a profit by buying specific securities of the listed company within six months of selling, or selling within six months of buying, regardless of whether they used insider information.

The comparison between this Article, which allows listed companies to claim the provision of short-term trading profits from officers and the insider trading regulations (Article 166 of the Financial Instruments and Exchange Act) is as follows:

	Provision of Short-Term Trading Profits	Insider Trading Regulations
Protected Legal Interest	Ensuring investor confidence in the fairness and soundness of the market	
Purpose	Preventing officers or major shareholders of listed companies, etc., from improperly using secrets obtained through their duties or positions	Prohibition of trading stocks by company insiders, etc., based on undisclosed important facts known through their assignments or positions
Targeted Actors	Officers or major shareholders of listed companies, etc.	✓Company insiders of listed companies, etc. ✓Persons who received important facts from company insiders
Targeted Actions	Making a profit by trading specific securities of the listed company, etc., within six months	Trading stocks, etc., of the listed company, etc., based on important facts known before they are disclosed.
Effect of Targeted Actions	The listed company can claim the provision of the profit from officers, and if claimed, officers are obliged to provide the profit	Violators are subject to criminal penalties and/or administrative fines. The administrative fine is equivalent to the economic gain calculated by the statutory method.

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Other	Improper use of secrets by the actor is not a requirement	The presence or absence of gain by the actor is not a requirement.

III. Issues with This Article (Article 164, Paragraph 1 of the FIEA)

1. Irrationality of Means to Achieve Purpose

   It is not rational as a means to achieve the purpose to claim the provision of the profit solely based on the fact that the person was an officer or major shareholder, even if no one suffered any damage and no secrets were improperly used, and the profit was obtained through short-term trading. The provision that deems improper use of secrets solely based on the fact of holding a certain position is clearly excessive regulation. Moreover, for those regulated, it is quite possible to evade this regulation by adjusting the timing of trading the stock to obtain a profit. Thus, while the regulation is insufficient on one hand, it does not require improper use of secrets on the other hand, and it can forcibly take away profits obtained without any issues, which seems to lack balance as a means.

2. "Officers" and "Major Shareholders" are treated equivalently

   There is also a problem in treating "officers" and "major shareholders" equivalently. A "major shareholder" is defined as a shareholder who substantially holds 10% or more of the voting rights of all shareholders, etc. (Article 163, Paragraph 1 of the FIEA). However, while "officers" can basically access all information of the company, the information that a shareholder holding only 10% of the voting rights can obtain is not significantly different from the information that general investors can obtain.

   Even if a shareholder holds 10% of the voting rights of a listed company, not as a parent company or related company, there is no information automatically obtained from the "position of a major shareholder."

   Thus, regardless of the significant differences in access to inside information between "officers" and "major shareholders," it is unreasonable to treat them equivalently.

3. Misunderstanding of the Purpose of This Article

   The purpose of this Article, as clearly stated in the text, is "to prevent officers or major shareholders of listed companies from improperly using secrets obtained through their duties or positions." However, we are not aware of any cases where this Article has been applied to trading using inside information. In reality, there are cases where major shareholders unintentionally engage in transactions that meet the formal requirements.

   Some who discuss this Article misunderstand its original legislative intent of "preventing the improper use of secrets by officers, etc.," and instead interpret it as aiming to sanction investors who make short-term trading profits through "conspicuous" actions in the market, using it for negative campaigns against activist investors.

Despite the many issues with this provision, its constitutionality concerning the infringement of property rights has been recognized by the Supreme Court of Japan (February 13, 2002) and

subsequent lower Courts' judgements.

IV. Derivative Issues

1. Interpretation of Trading "On one's own account"

   Under this Article, a listed company can claim the provision of trading profits from its officers, if the officers make a profit by buying within six months after selling or selling within six months after buying on their own account. The meaning of "on one's own account" becomes an issue here. If a trust trades the shares of the listed company, it is considered to be trading "based on the instructions" of the officers (Cabinet Office Ordinance on the Regulation of Securities Transactions, etc., Article 28).

   This is because trading based on the instructions of the beneficiary of the trust is considered equivalent to the beneficiary trading on their own account. Therefore, if an asset management company has entered into a discretionary investment contract with an investor and holds 10% or more of the shares, the investor, as a major shareholder, is not considered to have traded "on their own account" if they did not give trading instructions, and neither is the asset management company. This interpretation is established theory.

2. Handling of specific securities, belonging to the assets of Specific Partnerships, etc. (Article 165-2 of the FIEA)

   Article 165-2 of the FIEA was newly established on September 30, 2007, when the Securities and Exchange Act was reorganized into the FIEA. This provision stipulates the system for claiming the provision of short-term trading profits, etc., for members of partnerships, investment Limited Partnerships, Limited Liability Partnerships, or similar entities specified by government ordinance, where the voting rights belonging to the assets of such entities account for 10% or more of the total voting rights of the listed company, etc.

   This provision expanded the scope of the short-term trading profit provision system, etc., to include Partnerships without corporate status and foreign partnerships. The fact that triggered the establishment of this provision was a prior confirmation procedure for the application of Article 163 of the Securities and Exchange Act conducted by the Financial Services Agency of Japan on July 15, 2002, and the response on September 6, 2002, stating that "the partnership itself does not fall under the 'major shareholder' of Article 163." The inquiry on July 15, 2002, was made by the former Murakami Fund, and the so-called Murakami Fund Incident occurred in 2006, with the establishment of this provision in 2007, during a time when public sentiment against activist funds was extremely strong. The addition of this provision, which imposes regulations on short-term trading profits almost equivalent to those for major shareholders, even on specific partnerships, etc., seems to have been implemented under the influence of somewhat hysterical public sentiment, losing sight of the original purpose of "preventing the improper use of secrets obtained through duties or positions by officers or major shareholders of listed companies." As previously mentioned, this provision (then Article 164 of the Securities and Exchange Act) was

unreasonable, and expanding its scope was inappropriate legislation.

VII. Conclusion

Since the announcement of "Abenomics" by the former Prime Minister Abe's administration in 2013, Japan's capital market reforms have progressed significantly. In 2014, the Japanese version of the Stewardship Code was established, and in 2015, that of the Corporate Governance Code was established. Institutional investors and financial institution-affiliated asset management companies, which often endorsed company proposals at shareholders' meetings, are increasingly exercising their voting rights under strict judgment.

Since the previous Prime Minister Kishida's administration, the government has aimed to realize a "Policy Plan for Promoting Japan as a Leading Asset Management Center" and in 2024, the Nikkei Stock Average reached a new high for the first time in 35 years. Shareholder activism has become more common, and engagement activities and shareholder proposals by activist investors are being re-evaluated as activities that demand "efforts to improve corporate value" from management by shareholders, who are the owners and sovereigns of the corporation.

In such a context, it is excessive regulation beyond necessity and reasonableness to require major shareholders to provide profits to the issuing company, which has not suffered any damage, solely based on the facts of being a major shareholder and making a profit from short-term trading.

Additionally, some argue that "the inability to apply Article 164, Paragraph 1 to asset management companies that have entered into discretionary investment contracts with trusts is a defect in the law," but this seems to be influenced by general investors' "envy" and resentment or dislike towards activist funds.

The system of mandatory provision of short-term trading profits, which was merely inherited from U.S. law under post-war occupation, could hinder legitimate economic activities by shareholders, and this Article should be promptly abolished.

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