

# ClientAlert

## Tokyo Financial Services Group

March 2013

### FSA's Proposal to Amend the Existing Laws and Regulations with respect to Short Sales

On March 7, 2013, the Financial Services Agency of Japan (the "Japan FSA") announced that it is considering amending certain aspects of the existing rules and regulations governing short sales by November 2013. This Client Alert is a summary of the key changes proposed by the Japan FSA in its announcement.

#### 1. General Changes

##### (i) Permanent Effectiveness

In October 2008, the rules and regulations governing the prohibition of "naked" short sales and the reporting of a trader's short sale positions were introduced as tentative emergency measures being effective for periodic terms. While the Japan FSA has repeatedly renewed such terms in the past and will continue to do so until the effective date of the new amendments, under the proposed amendments, the effective period of these regulations will now be permanent.

##### (ii) Proprietary Trading Systems

The current rules and regulations on short selling are generally only applicable to those trades which are made on financial exchanges (e.g. the TSE). Under the proposed amendments, the scope of the short sale rules and regulations will be broadened to cover short sales made on certain types of proprietary trading systems (limited to those using auction, matching client orders or bid or offer price indications methods).

#### 2. Changes to the Reporting of Short Sale Positions

Currently, if the short sale balance ratio of a trader is 0.25% or more, such trader is required to submit a report to its broker disclosing its short sale position and this information will be publicly available on the website of the relevant exchange. The following amendments are being proposed to the existing short sale reporting rules.



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#### (i) Implementation of So-Called “Two-Tier Model”

Under the proposed amendments, two separate tiers for reporting of short sale transactions would be created based on the short sale balance ratio of the relevant trader.

If the short sale balance ratio of the trader is 0.2% or more but less than 0.5%, the trader will be required to make a report to its broker. In contrast to the existing reporting rules, this information would no longer be made available to the public.

If the short sale balance ratio of the trader is 0.5% or more, the trader will be required to submit a report to its broker. Unlike the report for short sale balance ratios less than 0.5%, this information will be made available to the public by posting on the website of the relevant exchange.

With respect to ongoing reporting, an amendment report will be required to be submitted to the relevant broker by the trader for every 0.1% change in its short sale balance ratio, including when the short sale balance ratio drops below the 0.2% threshold. Furthermore, it should be noted that when the short sale balance ratio drops below the 0.5% threshold, the relevant amendment report in connection with such change will also be made public.

#### (ii) Off-Market Transactions

Under existing rules, traders are required to report short sale balances only in respect of short positions on an exchange. In the language of the proposed amendments, the Japan FSA stated that traders will be required to report short sale balances on their “aggregate short positions”. Unfortunately, no further clarification was provided by the Japan FSA on the application of “aggregate short positions” particularly in connection with off-market transactions.

In response to our request for clarification, the Japan FSA commented that they are considering amending the scope of the trades covered under the short sale report to include certain off-market short positions. However, at this time, no specifics have yet been decided, and, should the Japan FSA make a determination that off-market short positions will be covered under the amended rules, it is possible that an off-market transaction may trigger an obligation on the trader to issue a short sale report.

The proposed amendments do not at this time specifically address the treatment of “synthetic shorts” created using swaps and derivative products, but it is possible that such positions will also be addressed in the final regulations issued after the public comment period.

### 3. New “Trigger” System to Apply the Uptick Rule

Currently, the uptick rule applies to all short sales in Japan. Under the proposed revisions, the uptick rule will only apply to trades of stocks that are trading 10% below the previous day’s closing price and the uptick rule would apply until the end of the following trading day.

This “bandwidth allowance” would be a major change to Japan’s short sale rules. We anticipate that it could facilitate trading and compliance record-keeping, especially by algorithmic traders and liquidity providers for whom existing short sale rules can require burdensome mechanisms and/or procedures to deal with the uptick rules.

### 4. Other Changes

#### (i) Changes to the Exemptions from the Short Sale Rules

Under the current rules, various types of trades are exempt from the existing short sale rules and regulations. Under the proposed amendments, the types of exempted trades will be expanded (e.g. arbitrage transactions between an exchange and a PTS).

#### (ii) Application to Improper Trades

Under the proposed amendments, trades that are made for the specific purpose of avoiding the application of the short sale rules may be covered as well. In the proposal, the FSA provides an example trade where a brokering firm undertakes trades on their “proprietary book” to disguise underlying short trades by their customers.

The March 7, 2013 announcement only sets forth the conceptual framework for changes to the existing rules and regulations and the Japan FSA has not released any of the proposed amendments to the relevant enforcement orders and cabinet orders. It is anticipated that the language of such proposed amendments will be available some time later this year (probably by late summer) subsequent to the closing of the public comment period and it is expected that the new rules eventually will become effective in November 2013.

The Japan FSA is soliciting comments from the public with respect to the proposed amendments to the short sale regulations. The official deadline for the acceptance of comments is April 8, 2013 and the Tokyo Financial Services Group would be pleased to assist any client wishing to submit comments to the Japan FSA.

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