
Environments for Stock Buybacks in Japan

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With the enactment of the Financial System Reform Law and with new market regulations drawing increasing attention, stock exchanges have announced guidelines to facilitate companies wishing to buyback their own stocks on the market, as well as a specialized market and a specialized scheme for this purpose. The measures taken by stock exchanges to smooth the companies' open-market stock buybacks will provide clear guidelines and means to ensure flexibility and maneuverable for such buybacks in terms of corporate finance strategies.

1. Market Regulations regarding Stock Buybacks in Japan

1) Significance of the Safe Harbor Rule in the U.S. Laws

The announcement of a company's plan to buyback stocks tends to push up its stock price because it is tantamount to the expression of confidence in the issuing company's business performance and because it has an announcement or signaling effect that the stock price is undervalued. In the United States, the SEC stipulates a safe harbor rule to prevent buyback stocks on the market from being regarded as market manipulation. This helps the company to avoid antifraud procedures in the process of purchasing its own stocks when the buyback is executed under prescribed conditions (Rule 10b-18 of the Securities Exchange Act of 1934).

In view of the experience of Black Monday in 1987, the Securities Exchange Act of 1934 stipulates four conditions (Rule 10b-18(b)): orderer (one broker or dealer per day), time (prohibited for 30 minutes after the exchange opens and for 30 minutes before it closes), price (the higher price within the trading price made at a level close to independent high bids either in stock exchanges or on ticker tape), and volume (up to 25% of average daily turnover for the past four weeks). This stipulation is binding on companies' open-market stock buyback.

2) Reluctance to Open-Market Buybacks

Since stock buybacks in Japan has been practiced largely by means of retirement of buyback stocks with retained earnings, which was approved by the amended Commercial Code in 1994 (Articles 210-2 and 212-2). At the same time, provisions regarding stock buybacks were also included in the Securities and Exchange Law. However, no clearly defined methods for such purchase are legally specified on the ground that a system like safe harbor rule in the U.S. laws does not apply to Japanese legal system.

After some discussions regarding the amendment of the Securities and Exchange Law, the Special Fair Trade Sub-committee of the Securities and Exchange Council released a report on February 7, 1994, in which some methods of stocks buyback that might be regarded as market

manipulation are listed. The list is not legally binding, but it is accepted as a guidepost for open-market stock buybacks.

Issuing companies have been reluctant to retire the buyback stocks with retained earnings for the reason that the buyback might be regarded as market manipulation or insider trading in violation of the Securities and Exchange Law (Articles 159 and 166 of the Securities and Exchange Law). Since the buyback through takeover bids, which are executed outside of the market in accordance with the procedure stipulated by the Securities and Exchange Law, ensures the buyback of large amounts of own stocks at one time without violating the rule against market manipulation, it has been preferred to buyback on the market. However, it is pointed out that such off-floor buyback has some disadvantages including the difficulty in flexible buyback responding to market conditions and the high cost involved.*¹

3) Various Forms of Stock Buybacks

Many forms of stock buybacks are available to prevent market manipulation when purchased on the market. They include: (1) discretionary investment contracts with investment advisors, (2) transaction discretionary investment contracts with securities companies, and (3) trust contracts with trust banks. All these methods enable a company to execute smooth and flexible buyback on the market without violating the regulation against market manipulation by establishing a Chinese Wall, but their transaction costs are higher than when the company places an order by itself on the market.

2. Stock Exchanges' Guidelines for Stock Buybacks

Guidelines for stocks buybacks were announced by the Tokyo Stock Exchange (TSE) on December 15, 1998 and by the Osaka Stock Exchange (OSE) on December 18, 1998. These guidelines are designed to help companies which plan to buyback their own stocks achieve this smoothly while remaining in compliance with the regulations against market manipulation and insider trading that are prohibited under the Securities and Exchange Law. They are also intended allow companies to gain a better understanding of both the criteria by which to judge actions that might be considered as market manipulation, and advice to better understand the monitoring guideline to avoid infringing on insider trading regulations.

1) Measures against Market Manipulation

Table 1 shows the criteria for a listed company, which executes buyback stocks, to judge whether or not its actions comprise market manipulation in terms of price, timing, the number of stocks to purchase, and its broker. It is advised to buyback its own stocks on the bases of entrustment contracts with securities companies or trust banks to prevent the acquisition from being suspected of being market manipulation.

*1 The market price of a company, which has purchased its own stocks through a TOB, during the TOB period is sometimes lower than the TOB price, and thus market purchase can be more advantageous (Tokyo Stock Exchange Data 2, Jan. 19, 1999).

2) Measures in Compliance with Insider Trading Regulation

Material facts in inside trading regulations regarding stock buybacks include (1) a board of directors' decision to make stock buyback a agenda of the annual shareholders meeting, and (2) decisions on actual buybacks (specific day of buyback and specified volume) at a board of directors' meeting. A company, as an insider, can buyback its own stocks without disclosing the decision (Clause 4-4-2, Article 166 of the Securities and Exchange Law). However, insiders such as directors and finance personnel cannot engage in trading without such disclosure. Disclosure of actual stock buybacks in advance is required as they might be considered to comprise market manipulation. In the recent guidelines, stock exchanges consider the following treatment of these matters to be desirable.

Table 1 Criteria for Judging Possible Market Manipulation in Stock Buybacks

Items	Contents
(1) Price	① Whether the company buybacks at the opening of the morning session (or at the opening of the afternoon session when no transaction was made during the morning session) at a price higher than the previous day's closing price or final quotations. ② Whether the company buybacks repeatedly and continuously at a price higher than the latest contract price or quotations. ③ Whether the company buybacks repeatedly and continuously in a way to sustain the level of the latest contract price (Note 1).
(2) Timing	① Whether the company buybacks within 30 minutes before the closing of the afternoon session (or the morning session when it is a half-day trading)(Note 2). ② Whether the company buybacks within a week before the last day of the fiscal term (including semiannual term). ③ Whether the company buybacks during the period when public or secondary offering prices of stocks, convertible bonds, and bonds with warrant can be affected, or during public or secondary offering.
(3) Number of Buybacked Stocks	Whether the number of buybacked stocks exceeds 25% of the average daily turnover for a month prior to the purchase. The turnover is taken into consideration for stocks with low liquidity (Note 3).
(4) Broker	Whether the company buybacks through several brokers during one day.
(5) Others	Whether the company spreads a rumor regarding the buyback plan, specific day of planned buyback, the planned volume of buyback and methods of buyback, or takes similar action.

Note 1: This questions whether the price is pegged, for instance, by buying back own repeatedly at a limit price close to the latest contract price even when it is possible to buy at a price lower than the latest contract price.

Note 2: It means the orders are made within 30 minutes before the close of the afternoon session.

Note 3: The number of stocks by the so-called prior announcement-type buyback is excluded from the number of daily purchase.

Source: Nomura Research Institute

Table 2 Points to Note in Preventing Insider Trading

Items	Points to Note
(1) Points to note in preventing an executive, etc. of a company, who knows undisclosed decisions on the actual buybacks, from trading the company's stocks personally.	<p>① It is necessary to strictly control information on the actual buyback, and to establish an in-house control system, under which persons other than those involved in the decision on the stock buybacks, or those in charge of unified control of material facts, are unable to gain access to that information. It is also important to establish a system that requires executives, etc. of the company, who personally buy or sell the company's stocks, to report in advance to the person in charge of unified control of material facts, who oversees whether the executives, etc. are involved in the actual buyback.</p> <p>② When the company's own stocks are buybacked by entrusting securities companies, etc. regarding such items as the time and price of buyback based on discretionary investment contracts with the securities companies, etc., there should be a guaranty in the contracts that the information on the decisions on actual buybacks be adequately controlled by the securities firms, etc.</p> <p>③ It seems to be effective to designate the period when actual buybacks are not executed and disclose this information.</p> <p>④ When the stock buybacks are finished before the end of the acquirable period, the type, total number and total value of the stocks purchased should be disclosed (or the reason when purchases are discontinued).</p>
(2) Points to note in preventing those involved in decisions on the actual buybacks from purchasing the company's stocks after knowing undisclosed material facts about the company.	<p>① When other material facts arise, they should be made public as soon as possible.</p> <p>② Information on other material facts should be strictly controlled, and an in-house control system should be established which prevents those involved in decisions on specific individual purchases from learning other material facts.</p> <p>③ It is an effective means to buyback stocks by entrusting securities firms, etc. with regard to the time and price of buybacks based on the discretionary investment contracts with them.</p>

Source: Nomura Research Institute

3. Measures Taken by Stock Exchanges to Promote Buyback Stocks on the Market

The methods currently being used for stock buybacks are by TOB or by discretionary investment contracts. However, these methods do not meet the company's need for flexible buyback in terms of referring to stock price levels and trading on the market on the basis of the issuing company's capital policy and finance strategy.

Stock exchanges are preparing to meet such requests of listed firms, and create opportunities for acquisitions of the company's own stocks, in response to the elimination of compulsory limiting of trading in the market in December 1998. The Nagoya Stock Exchange (NSE) launched the system for off-floor trading of company's own stocks on December 1, 1998. The Tokyo Stock Exchange announced on January 20, 1999 a proposal for "buyback by prior disclosure" by the issuing company, as a new scheme to support smooth open-market stock buyback, rather than a market specialized in purchase of own stocks as established by the NSE.

1) The NSE's System Specialized in Off-Floor Purchase of Own Stocks

This is a specialized system for listed companies to purchase its own stocks for the purpose of retirement (Article 46-2 of the NSE Rules). Under this system, the issuing company is required to report the number of stocks and other items on the day preceding the day of buyback to the NSE, while the NSE should disclose the relevant information and receive sell orders in the morning of the day (from 8:20 to 8:45 AM) following the day of the report, and settle trading in bulk off the floor. The trading price should be the previous day's closing price. When there are many sell orders,

stocks are divided in proportion to the number of offered stocks. The results of off-floor trading are released on each occasion.

Two companies have buybacked since the off-floor buyback is introduced, Nihon Hi-pack on December 15, 1998 and Takeda Printing on December 21, 1998. Their ratios of actual buybacks to the projected number of stocks were 64.2% and 90.6% respectively, which show a very high level of fulfillment for a day's purchase.

2) TSE's New Scheme for Stock Buyback

On January 20, 1999, TSE announced the "prior disclosure-type buyback" method as a new scheme for stock buybacks to deal with selling by major shareholders, using the general auction market and the ToSTNet-2 (Tokyo Stock Exchange Trading Network System-2; trading at the closing price).^{*2}

The prior disclosure-type buyback is executed, when selling by large shareholders is planned, on the auction market or through ToSTNet-2, on the day of buyback by disclosing specific contents of the buyback on the previous day. This system can cope with dissolution of cross holding of large shareholders. It ensures trading opportunities for general shareholders and guarantees fairness and transparency of trading. On the auction market (which opens after 9:00 AM) which is operated by the price-first and time-first rules, the price when trading is effected will become the buying price. On the ToSTNet-2 (which opens at 8:45 AM only), the closing price of the previous day is used as the selling price.

The issuing company is required to decide on specific content of the buyback on the previous day, request large shareholders, etc. to sell their shares based on that specific content, and disclose the specific content of the buyback to two or more news organizations after the end of trading on the previous day. It is also required to disclose the specific results of its buyback after finished.

3) Legal Measures relating to "Disclosure Requirement"

"Disclosure Requirement" in insider trading regulations means "to disclose to two or more news organizations including publishers that sell daily papers, or news agencies, followed by a lapse of 12 hours" (Article 30 of the Cabinet Order for the Enforcement of the Securities and Exchange Law) prior to stock buyback. In off-floor buyback on the NSE, the issuing company is required to hold a press briefing at the NSE and follow the procedure based on legal measures of disclosure such as announcements in newspapers. Prior announcement by the new scheme for prior-purchase type of stock buyback at the TSE can avoid insider trading that might occur on the selling party, because the day of buyback is preceded by more than 12 hours following the announcement.

^{*2} In ToSTNet-2, general investors can participate in trading, regardless of the volume of their orders, after confirming the closing price or VWAP and considering the issues and sell and buy volumes. When their orders cannot be executed during the session or at closing quotations, an opportunity is provided for them to trade at the closing price, etc. after the session. In ToSTNet-1, institutional investors can anonymously find trading partners for large-lot orders of a certain size on the network, negotiate with them individually, and effect trading.

4. Conclusion

It is significant for stock exchanges which are voluntary regulatory organizations, that they have worked out guidelines and new methods for stock buybacks. These steps mean that companies now have wider actual options, from the viewpoint of their finance strategy, in open-market stock buyback.

However, as of now, no clear legal position has been established with regard to the method of open-market stock buyback. The Financial Supervision Agency (FSA), which is in charge of supervision and exposure, has decided on a policy to focus its efforts on supervision and exposure of market manipulation. It is expected that the agency will announce its attitude toward the points to note in securities trading, such as stock buybacks, which attract strong interest. Separate roles for the securities and exchange system are assigned, planning and drafting to the Ministry of Finance (MOF), and supervision and exposure to the Financial Supervision Agency. The MOF and the FSA should coordinate their separate interpretations and provide clearly defined interpretation of the system.