

**CAPITAL MARKETS NEWS IN JAPAN****Mizuho Securities, acting as Lead Underwriter, Judged Liable for Damages, by Japan's Supreme Court – the First Such Case in Japan's Judicial History Relating to IPOs****December 29, 2020**

On December 22, 2020, Japan's Supreme Court held that Mizuho Securities, which acted as lead underwriter in connection with the initial public offering of FOI, a Japanese manufacturer of semiconductor-manufacturing equipment, is liable for damages, by stating to the following effect:

In the event that the relevant lead underwriters come into contact with information that raises serious doubts about the basis of reliability of the above-mentioned audit [conducted by outside certified public accountants with respect to the calculation part of any of the relevant securities registration statements] during the underwriting examination, they are required to investigate and confirm that the above-mentioned audit does not lack the basis of reliability, depending on the contents of such doubts. In the above case, if the relevant lead underwriter concludes a principal underwriting agreement without conducting the above-mentioned investigation and confirmation, it is understood that it lacks the premise for the exemption under the Financial Instruments and Exchange Act, Article 21, Paragraph 2, Item 3.

This case is the first one, in Japan's judicial history, which held that a lead underwriter is liable for damages arising from or in connection with an initial public offering in Japan.

For your information, attached hereto is a draft preliminary English translation of Japan's Supreme Court's judgment, dated December 22, 2020, referred to hereinabove.

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**[PRELIMINARY ENGLISH TRANSLATION (DRAFT)]**

4. However, the above-mentioned judgment of the appellate court cannot be approved. The reasons therefor are as follows:

(1) The Financial Instruments and Exchange Act provides in Article 21, Paragraph 1, Item 4 that if a securities registration statement contains a false statement of a material matter, or lacks a statement of a material matter that should be stated or a statement of a material fact necessary not to cause misunderstanding, the securities may not be offered or sold. In the event that any of the aforementioned false statements or deficiencies in statements (hereinafter collectively referred to as "false statements, etc.") is made to a person who has acquired the securities in response to the offer or sale, the underwriter shall be liable for compensation for damages caused by such false statements, etc. In the same Article, Paragraph 2, Item 3 states that if the underwriter proves the matters specified in the same item (reasons for exemption), the underwriter is not liable for the above-mentioned damages. This means that a financial instruments firm, etc. that intends to enter into a primary underwriting agreement shall not be liable for the above-mentioned damages if the financial instruments firm, etc. conducts an underwriting examination of the company issuing the securities and examines the information, etc. to be included in the securities registration statement based on its expertise. As financial instruments firms, etc. are in a position to conduct underwriting examinations of companies that are issuers of securities and examine the information, etc. to be included in the securities registration statement based on their expertise, the liability of underwriters for damages in the case of false statements, etc. are stipulated, pursuant to which the appropriateness of the underwriting examination should be confirmed and the credibility of disclosed information in the registration statement should be pledged by the underwriter.

However, the financial statements should be audited by a certified public accountant or an audit corporation that has no special interest in the company issuing the securities (hereinafter collectively referred to as an "independent auditor"). Certified public accountants should perform their duties fairly and sincerely as experts in auditing and accounting (Article 193-2, Paragraph 1 of the FIEA). If there are false statements, etc. in the financial statements, the independent auditor who made the audit certification as if there were no false misstatements, etc. shall be liable for damages unless it is proved that there was no intentional or negligent mistake in making the audit certification (Article 21,

Paragraph 1, Item 3, Paragraph 2, Item 2, Article 22 of the FIEA and Article 21(1)(iii), (2)(ii) and (22) of the FIEA). Article 21(2)(iii) of the FIEA provides that, in order for an underwriter to be exempted from liability for the above-mentioned grounds for exemption, if there are false statements, etc. in any part other than the financial calculation part, the underwriter must, for the purpose of it being exempted from liability, prove that it was not able to be aware of such false statements, etc. despite it having exerted its reasonable care. On the other hand, if there are false statements, etc. in the financial calculation part, the underwriter must, for the purpose of it being exempted from liability, prove that it was not aware of such false statements, etc. The provision of the same Item regarding the case where there are false statements, etc., in the financial statements is intended to allow financial instruments firms, etc., who intend to enter into a primary underwriting agreement, to conduct underwriting examinations by relying on the audit of the financial statements by independent auditors from the viewpoint of a reasonable division of roles with independent auditors. It is a natural premise that the financial instruments firms, etc. should be able to rely on the above audit.

If this is the case, the above financial instruments firms, etc. should not have serious doubts about the basis of reliability of the above audit in their underwriting examination. In the event that the financial instruments firms, etc. come into contact with information that raises serious doubts about the basis of reliability of the above-mentioned audit during the underwriting examination, they are required to investigate and confirm that the above-mentioned audit does not lack the basis of reliability, depending on the contents of such doubts. In the above case, if a financial instruments firm, etc. concludes a principal underwriting agreement without conducting the above-mentioned investigation and confirmation, it is understood that it lacks the premise for the exemption under the same Item.

Therefore, if there are false statements, etc. in the financial calculation part, and the underwriter had access to the above information during the underwriting examination, it is reasonable to conclude that the underwriter cannot be exempted from liability for damages under Article 21, Paragraph 1, Item 4 of the FIEA unless it has conducted the above investigation and confirmation.

(2)a. With respect to this case, according to the aforementioned facts, the financial

statements for the respective Fiscal Years<sup>1</sup>, which were audited by the Accountants<sup>2</sup> under Article 193-2, Paragraph 1 of the Financial Instruments and Exchange Act, in the securities registration statement in question, show that the Company<sup>3</sup> has been continuously posting false statements in question in respect of the recording of large amounts of fictitious sales since around 2004. Accordingly, it is recognized that there were false statements in respect of material matters in the financial calculation part of the securities registration statement in question.

In addition, the Special-Appellee<sup>4</sup> had received each of the Letters<sup>5</sup> in the course of the underwriting examination of the Company. These Letters pointed out that most of the sales of the Company since the fiscal year ended March 2004 were fictitious. The above-mentioned points well correspond with the fact that the Company, in its financial statements, etc., has shown, since around 2004, a rapid increase in sales, unevenness in the timing of recording sales, a significant increase in the year-end balance of accounts receivable, a notably prolonged turnover period of accounts receivable, and continuous negative cash flow from operating activities, which are events that can be considered typical signs of sales falsification, and were continuously observed. In addition, each of these Letters concretely pointed out, in a detailed manner, the method and contents of the rigging-accounting by, among other things, (i) containing statements that were consistent with the facts known to the Special-Appellee, such as the names of the officers in question,

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<sup>1</sup> Translator's Note: The term "Fiscal Years" herein means the Company's fiscal years ended March 2008 and March 2009.

<sup>2</sup> Translator's Note: The term "Accountants" herein means the certified public accountants who conducted the audit of the Company's calculation documents and financial statements with respect to its fiscal years ended March 2002 or thereafter.

<sup>3</sup> Translator's Note: The term "Company" herein means Kabushiki Kaisha FOI, a Japanese corporation listed on the Tokyo Stock Exchange Mothers.

<sup>4</sup> Translator's Note: The term "Special-Appellee" herein means Mizuho Securities Co., Ltd.

<sup>5</sup> Translator's Note: The term "Letters" herein means, collectively, the First Letter and the Second Letter. The term "First Letter" herein means the letter pointing out the account-rigging of the Company which the Special-Appellee received from an anonymous sender on or about February 14, 2008. The term "Second Letter" herein means the letter pointing out the account-rigging of the Company which the Special-Appellee received from an anonymous sender on or about October 27, 2009.

the sales manager in question of the Company, and the person in charge of the Special-Appellee, as well as the sales amount and sales details of the Company, and (ii) asserting that the officers in question conspired to falsify most of the evidentiary records by securing the cooperation of Fujitsu and other companies, and posted fictitious sales by such methods as faking the delivery of products by actually taking them out of the warehouse. Therefore, it is quite possible that these Letters were prepared based on the facts by someone inside the Company.

If the above-mentioned is the case, (i) each of the Letters can be recognized as those creditably pointing out that there are material false statements in the sales columns, etc. of the financial statements for the most recent fiscal year and the fiscal year immediately preceding the most recent fiscal year that should be included in the securities registration statement of the Company, and (ii) it should be recognized that the Special-Appellee, by receiving these Letters, was exposed to such information as would raise serious doubts about the basis of the reliability of the audit of the relevant financial statements by the Accountants<sup>6</sup>.

(2)b. The Special-Appellee has been involved in the underwriting examination of the Company as the lead manager of the Company, and has requested the Company to present necessary materials in response to the contents of the above-mentioned questions raised by the Letters. It can be said that the Special-Appellee could have conducted (and was expected to conduct) various investigations regarding the reliability of the above audit, such as requesting the Company to present necessary materials, interviewing the Accountants, and requesting the Accountants to make an additional investigation report. The Special-Appellee, however, did not do so.

Even though the First Letter pointed out that falsification was being done at the initiative of the officers in question, the Special-Appellee immediately informed the officers in question of the contents of the First Letter, and, after receiving an explanation that that the First Letter was sent by an employee of the Company with the intention of obstructing business, the Special-Appellee took inappropriate actions such as requesting the punishment on the author of the First Letter. In addition, even though the person who

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<sup>6</sup> Translator's Note: The term "Auditors" herein means those public certified accountants who conducted the audit of the Company's calculation documents and financial statements with respect to its fiscal years ended March 2002 or thereafter.

seemed to be the author of the First Letter was the head of the Internal Audit Office, the Special-Appellee still did not interview the person even after receiving the Second Letter. In the first place, the Special-Appellee made a gross mistake in evaluating the credibility of each of these Letters. Although the Special-Appellee confirmed, after receiving the First Letter, that there was no fact that stock options were granted to the persons related to Fujitsu as pointed out in the First Letter, this fact does not immediately mean that each of the Letters is not credible.

The Special-Appellee confirmed that there were no particular problems in the audit performance and audit system of the Accountants before receiving the First Letter, and confirmed the contents of the audit procedures performed by the Accountants before and after receiving each of the Letters. However, the audit procedures for the above-mentioned hearing were merely to confirm the existence of accounts receivable by the balance confirmation instruments that were returned to the Accountants from the sales counterparty. The possibility of the falsification of the settlement of accounts by the method pointed out in each of these Letters, in which most of the evidentiary documents including order forms, acceptance receipts, etc., were forged with the involvement of the collaborators of the Counterfeiting Business Partners<sup>7</sup>, was not considered. In addition, the Special-Appellee has not even specifically confirmed whether or not the original vouchers were confirmed in the above audit procedures. It cannot be said that the Special-Appellee confirmed whether or not the audit procedures sufficient to deny the possibility of falsification by the above-mentioned methods were implemented.

Before receiving the First Letter, the Special-Appellee conducted a visit to two of the Counterfeit Business Partners. In addition, as an additional investigation based on the First Letter, the Special-Appellee conducted a cross-check of evidentiary records concerning sales. However, the above-mentioned on-site survey was conducted in accordance with the Company's proposal, and one of the companies was answered by a person who could have been a cooperator in light of the contents of each of the Letters. In addition, the above-mentioned verification was limited to confirming that there was no contradiction between the copies of the evidence. These investigations cannot be said to be sufficient to deny the possibility of falsification by the methods pointed out in each

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<sup>7</sup> Translator's Note: The term "Counterfeit Business Partners" herein means those companies which were alleged to be business partners in relation to the fictitious sales in question.

of the Letters.

If this is the case, it can be said that the Special-Appellee, in its underwriting examination of the Company, neither investigated with respect to whether, nor verified that, the financial statements of the Company for the respective Fiscal Years do not lack the basis of reliability of the audit by the Accountants with respect thereto, taking into account the content, etc. of doubtfulness demonstrated by each of the Letters.

(2)c. Therefore, the Special-Appellee cannot be exempted, by the application of Article 21(2)(iii) of the FIEA, from liability for damages stipulated under Article 21(1)(iv) of the FIEA.

5. Therefore, the above-mentioned judgment of the appellate court which dismissed the claim for damages against the Special-Appellee with respect to the shares of the Company acquired in response to the primary offering or the secondary offering has an evident breach of law which would affect the judgment. The Special-Appellee's assertion is reasonable in that it points out this effect, and as a result, the part of the appellate court's judgment which dismissed such assertion cannot avoid being overturned. In order to complete the hearing on the amount of damages suffered by the Special-Appellants, the case shall be remanded to the appellate court.

As the reasons for filing a petition for acceptance of the final appeal were eliminated in the decision to accept the final appeal, the final appeal on the remaining claims of the Special-Appellants listed in the attached Exhibit 1 prepared by the Special-Appellants hereby is dismissed.

Therefore, with the unanimous opinion of the judges, the judgment is rendered as set forth in the main text.

(Presiding Judge Hiroko Miyazaki, Judge Saburo Tokura, Judge Keiichi Hayashi, Judge Katsuya Uga, Judge Michiharu Hayashi)