

(Provisional translation)

September 5, 2008

Financial Services Agency

## **Annual Supervisory Policies for Financial Instruments**

### **Business Operators, etc. for Program Year 2008**

In conjunction with the enforcement of the Financial Instruments and Exchange Act on September 30, 2007, the Financial Services Agency (FSA) systematically reorganized the content of the supervisory guidelines, etc., which had conventionally been established on a sector-by-sector basis, and compiled a comprehensive, cross-sectoral summary of its basic approach to the supervision process aimed at financial instruments business operators, etc., titled the “Comprehensive Guideline for Supervision of Financial Instruments Business Operators.”<sup>1</sup> The Guideline requires the FSA to establish and publish its supervisory policies for each program year, so as to clarify key supervisory issues.

At the time of establishing the Annual Supervisory Policies for Supervision for Program Year 2008, global financial markets remain tense, triggered by the subprime mortgage problem. Furthermore, the economy is weakening, and is exposed to further downside risks depending on movements in crude oil prices and other such factors<sup>2</sup>. In order to overcome these circumstances and enable the Japanese economy to experience sustainable growth, it is becoming increasingly important to provide good opportunities to invest household financial assets, as much as 1,500 trillion yen, and properly supply growth funds to companies and other institutions both at home and abroad.

This gives rise to the need to enhance the competitiveness of Japan’s markets and improve their appeal, in accordance with the Better Market Initiative (*Plan for Strengthening the Competitiveness of Japan’s Financial and Capital Markets*) published by the FSA in December 2007. Efforts are required on the part of financial instruments business operators, etc. to improve security and convenience for investors through compliance with the Financial Instruments and Exchange Act. They are also required to engage in business operations in recognition of the public nature of their

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<sup>1</sup> The Comprehensive Guideline for Supervision of Financial Instruments Business Operators is targeted at financial instruments business operators (type I financial instruments business, type II financial instruments business, investment management business and investment advisory & agency business), registered financial institutions, specially permitted businesses for qualified institutional investors, etc., foreign securities brokers, financial instruments intermediary service providers, securities finance companies and investment corporations.

<sup>2</sup> Cabinet Office’s “Monthly Economic Report” dated August 7, 2008 (<http://www5.cao.go.jp/keizai3/getsurei.html>)

roles as market intermediaries, and help build a reliable market infrastructure. On top of this, they are expected to establish appropriate internal control systems to provide higher-quality services, and at the same time, aggressively run their businesses.

## **1. Improving Security and Convenience for Investors**

The shift of funds from savings to investment cannot be accelerated without developing an environment in which ordinary investors can participate in investment activities with a sense of security. The FSA will properly implement the Financial Instruments and Exchange Act, check the financial soundness of each financial instruments business operator, and take a strict stance on unqualified business operators, in an effort to develop such an environment.

### **(1) Disseminating and Instilling the Financial Instruments and Exchange Act**

The FSA will check whether financial instruments business operators, etc. have developed appropriate systems to protect investors, as intended by the Financial Instruments and Exchange Act.

The Act not only seeks to protect investors but also aims to improve convenience for investors<sup>3</sup>. The FSA will check whether financial instruments business operators are being overly conservative at the expense of investor convenience, by closely monitoring the actual status of sales of investment trusts and by other such means, and will continue making efforts to disseminate and instill the spirit of laws and regulations based on collaboration with self-regulatory organizations.

### **(2) Eradicating Unqualified Financial Instruments Business Operators**

The FSA has come across applications being filed for financial instruments business registration by applicants who resorted to such illicit means as preparing and submitting deceptive documents, as well as financial instruments business operators that have lacked staff for executing business operations since being registered. These kinds of cases are problems that rock the foundation of the registration system, and pose the risk of destroying the credibility of financial instruments businesses. The FSA will take a strict stance on similar cases and endeavor to prevent such cases from arising again.

The FSA will collaborate with law enforcement authorities and take a strict stance on

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<sup>3</sup> Financial Services Agency's "Our Answers to Your Questions about the Financial Instruments and Exchange Act" dated February 21, 2008 (<http://www.fsa.go.jp/policy/br/20080221.html>)

unregistered financial instruments business operators. In particular, the FSA will strive to gather information on collective investment schemes (funds), which have been brought under the scope of regulation by the Financial Instruments and Exchange Act, given that fraudulent schemes have been found.

### **(3) Properly Managing Investors' Assets**

To ensure security and convenience for investors, it is important to make financial instruments business operators, etc. not only stabilize their financial positions, but also rigorously enforce the segregated custody and management of investors' assets to prevent investors' assets from being impaired even if concerns arise over their financial soundness. In particular, the FSA will check the compliance status of foreign exchange margin trading businesses, some of which have been found to have inadequacies in segregated management, and take appropriate regulatory actions.

## **2. Building a Reliable Market Infrastructure**

In order to enhance the competitiveness of Japan's financial and capital markets, the FSA will ensure fairness and transparency in the markets, and bolster the confidence placed in the markets. In addition, the FSA will develop a highly secure and convenient market infrastructure in which a wide range of transactions can be executed smoothly and reliably.

### **(1) Facilitating the Dematerialization of Stock Certificates**

The dematerialization of stock certificates scheduled for January 2009 is beneficial to all market participants. To facilitate its implementation, the FSA will collaborate with related organizations and encourage financial instruments business operators, etc. to be prepared properly.

In particular, the FSA will verify whether the respective management teams of financial instruments business operators are fulfilling their responsibilities and demonstrating their leadership, in developing systems and operational procedures, making such procedures common knowledge among their officers and employees, and conducting training and performing various tests in an appropriate manner. In conjunction with this, the FSA will check whether they are properly prepared in practice, from the viewpoint of customer protection, to serve as the custodians of stock certificates for investors.

### **(2) Fulfilling Public Role as a Market Intermediary**

Financial instruments business operators, etc. are market boosters serving as market intermediaries when investors and fund raisers access the markets. The FSA will check whether they have developed compliance systems and internal controls systems that befit their public role in that sense, and whether the awareness of compliance, etc. has been thoroughly engrained among their officers and employees. In addition to this, the FSA will closely monitor their activities aimed at eradicating anti-social forces from markets, as well as their reporting status of suspicious transactions.

Moreover, the FSA will check their procedures for managing business continuity in the event of earthquakes, epidemics of new influenza viruses and other unexpected events.

### **(3) Further Enhancing Self-regulation Functions**

Self-regulation by associations (self-regulatory organizations) fulfills a key function as part of the market infrastructure, complementing discipline under laws and regulations. Accordingly, the FSA expects self-regulatory organizations to more effectively fulfill their functions, including conducting surveys, offering guidance and giving recommendations to their members. The FSA will also conduct studies on how to realize loophole-free self-regulation through enhanced collaboration with associations.

At the same time, the FSA will promote cross-sectoral efforts to bolster complaints resolution and mediation functions as a matter of urgency, and continue to make efforts so that the Certified Investor Protection Organization system will be utilized broadly.

## **3. Diversified, Sophisticated and Multinational Operations, Building Appropriate Internal Control Systems, etc.**

In order to create vibrant markets according to the Better Market Initiative (*Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets*), it is necessary to develop an environment in which financial instruments business operators can provide higher quality services based on their own innovative ideas. The FSA will closely monitor the management strategies of each financial instruments business operator, identify the extent to which their operations are diversified, sophisticated and multinational, and then check whether they have built appropriate internal control systems.

### **(1) Responding to Revamp of Firewall Regulations**

Given that the bill for amending the Financial Instruments and Exchange Act has been passed at the recent ordinary session of the Diet, the FSA will work to properly implement and facilitate the revamp of firewall regulations, enhancement of systems to manage conflict of interest, etc., according to the Better Market Initiative (*Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets*).

## **(2) Aggressive Business Operations and Appropriate Internal Controls**

Financial instruments business operators who are pursuing more diversified, sophisticated and multinational operations are required to build superior internal control systems, including developing systems to identify and immediately implement new additional measures that are needed to adapt to future changes in its operations and the environment by themselves. From this viewpoint, the FSA will check the preparedness of each financial instruments business operator.

On the other hand, the FSA will give due consideration to transparency and predictability when administering the Financial Instruments and Exchange Act so that, for example, innovative efforts made by financial instruments business operators to introduce new services that are approved in other countries would not be hampered by uncertainties over their treatment under Japanese laws and regulations.

## **(3) Managing Risks commensurate with Aggressive Business Operations**

The FSA will check the financial soundness of financial instruments business operators, etc. while paying attention not only to the trends in financial and capital markets, but also to the impact of fluctuations in the commodities market and the real estate market. In particular, the FSA will check whether type I financial instruments business operators have calculated, disclosed and reported their capital adequacy ratio correctly, and then properly implement the early warning system introduced following the revision of the Supervisory Guideline in April 2008.

When checking the financial soundness of each financial instruments business operator, it is necessary to keep in mind that the nature of financial instruments businesses (conventional securities businesses, etc.) is constantly changing, as exemplified by the changes brought about by the expansion of off-exchange trading. Given the increasing number of financial instruments business operators involved in sophisticated operations, such as packaging and selling complex securitized products, the FSA will check whether they are properly executing risk management in response to such trends.

Furthermore, there is an ever-growing tendency among financial instruments business operators to diversify operations, as exemplified by their participation in diverse investment products markets and the expansion of so-called "principal investments". The FSA will make fact-finding

efforts in this area and check whether financial instruments business operators are properly executing risk management to prevent customers (investors) of financial instruments businesses from suffering unexpected impact.

Especially with respect to internationally-active financial instruments business operators (groups), the FSA will check their group-wide risk management systems and strive to accurately identify the impact on their financial soundness. Moreover, considering that a major investment bank overseas suffered deterioration in cash flow, triggered by concerns over counterparty risks, the FSA will check the liquidity risk management systems of financial instruments business operators by drawing a lesson from this incident.

#### **(4) Enhancing Proper Risk Assessment of Securitized Products and Disclosure of Information**

Suggestions have been made about the need to improve traceability by making each party to securitization properly assess the risks of the underlying assets and provide information on such risks. The FSA will continue developing a framework to improve traceability by collaborating with market players.

#### **(5) Dealing with Various Funds**

From the viewpoint of promoting financial efforts to build a low-carbon society, the FSA will gather information on examples of investment trusts that take environmental assessment into account when selecting investment targets (i.e., eco-friendly funds).

The FSA will also make as much fact-finding efforts as possible with respect to collective investment schemes (funds), which have been brought under the scope of regulation by the Financial Instruments and Exchange Act.

### **4. Materializing “Better Regulation”**

Improving the quality of financial regulation is important in order to make Japan’s financial markets more competitive. Also, financial regulation should place a greater emphasis on voluntary efforts and innovative ideas by financial firms, in light of the current phase of Japan’s financial sector where it should continue and further refine its efforts to stabilize the financial system, protect customers, and establish and maintain fair and transparent financial markets.

Under these circumstances, the FSA will continue to be engaged in the efforts to solve supervisory issues in program year 2008 based on “better regulation” which centers on the following

four pillars. The agency will have all its supervisory staff appreciate the concept and materialize it by the following efforts.

**(1) Optimal Combination of Rules-based and Principles-based Supervisory Approaches**

The FSA will utilize “The Principles in the Financial Services Industry,”<sup>4</sup> compiled in April 2008, in its financial administration , and interpret and implement the rules as they were originally intended.

**(2) Timely recognition of priority issues and effective response**

The newly-established Office for Market Analysis and Office for Supervisory policy, Financial Market and Risk Analysis will gather and analyze information on market trends and risks related to the financial system, and promptly reflect such information in supervising financial instruments business operators, etc. The FSA will also perform effective supervision by encouraging to cooperate more closely among supervisory divisions and the Securities and Exchange Surveillance Commission (SESC). Furthermore, the FSA will strive to collaborate closely with foreign supervisors, and to recognize priority international issues and respond to them effectively, in a manner consistent with the international community.

**(3) Encouraging voluntary efforts by financial firms and placing greater emphasis on providing them with incentives**

In order to share the same recognition about rectifying problems with financial instruments business operators, etc., the FSA will endeavor to analyze and unravel the causes extensively through two-way dialogues.

**(4) Improving the Transparency and Predictability of Regulatory Actions**

The FSA will strive to improve the transparency and predictability of its regulatory actions by enriching dialogues with financial instruments business operators, etc. and distributing more information to them. The agency will also properly provide feedback on the results of its fact-finding to the financial instruments business operators, etc.

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<sup>4</sup> <http://www.fsa.go.jp/news/19/20080418-2.html>

For the purpose of enhancing the effectiveness of such efforts, the FSA will endeavor to improve the skills of its staff by such means as cultivating and hiring experts, and enhancing training programs.