

(Provisional translation)

August 18, 2009

Financial Service Agency

Annual Supervisory Policies for Financial Instruments

Business Operators, etc. for Program Year 2009

The Financial Services Agency (FSA) publishes its Annual Supervisory Policies for Financial Instruments Business Operators, etc. for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.”¹, which show basic approaches for the supervisory process aimed at financial instruments business operators, etc.

In this Program Year, in accordance with “Basic Concept of Future Supervision” as shown below, the FSA will place priority on the two areas of 1) risk management and stability of financial system, and 2) improving customer protection and convenience for users, and will supervise financial instruments business operators, etc. while striving to have frank and deep discussions with them.

It should be noted that these supervisory policies were drawn up in light of the circumstances that surrounded financial institutions as of August 2009, and may be subject to review as necessary.

1. Experience of Financial Crisis and Basic Concepts on Supervision of Financial Institutions for the Future

Last program year, the turmoil in international financial and capital markets was triggered by the subprime mortgage problem and pushed to a state of crisis by the bankruptcy of major financial institutions in the US. It was a year in which the economic crisis affected not only financial

¹ The Comprehensive Guidelines 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.

and capital markets, but also the global economy as a whole, including Japan's real economy.

At the time of establishing the Annual Supervisory Policies for Financial Instruments Business Operators, etc. for Program Year 2009, the economy is showing movements of picking up recently while in a difficult situation. To achieve sustained growth of the Japanese economy, it is important that financial instruments business operators properly fulfill their market intermediary function of providing not only appropriate investment opportunities to financial assets in the consumer sector but also business enterprises with financial resources for growth. In line with the "Plan for Strengthening the Competitiveness of Japan's Financial Markets,"² the FSA will continue to foster increased competition and vitality in the financial services business in the Japanese market, thereby enhancing the attractiveness of the Japanese market to domestic and foreign users.

During the last program year, the FSA had been making efforts to deal with the financial crisis based on the concept of better regulation, and through this process, the importance of "Better Regulation" was reconfirmed.

Accordingly, the FSA is placing "Better Regulation" as a key component (engaging in frank and deep discussions with financial institutions, disseminating information to the outside, sharing and linking information on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of regulatory actions) and is striving to further have it become embedded and enhanced. In doing so, the FSA will pay attention to the following points in particular.

- 1) Financial institutions are expected to be aware of long-term managerial issues, conduct positive managerial reforms and make appropriate and responsible business judgments under the appropriate leadership of management personnel. The FSA will more than ever strive to (i) conduct financial administration with a high risk sensitivity that can detect at an early stage any risks that exist in each financial institution or financial system, (ii) conduct financial administration that further improves customer protection and convenience for users by looking at things from a citizen's and user's point of view, (iii) conduct financial administration that does not stop at short-term responses but that also thoroughly determines the progression of international discussions and considers environmental changes, while at the same time implementing long-term responses with an eye on the future, and (iv) help financial institutions autonomously improve management and make better business judgments via frank and deep discussions and the distribution of information.
- 2) The FSA, in addition to encouraging closer cooperation with the Securities and Exchange Surveillance Commission (SESC) and other affiliated divisions as well as with self-regulatory organizations (SROs) and the Bank of Japan (BOJ), will also strive to cooperate with overseas

² <http://www.fsa.go.jp/policy/bmi/index.html>

authorities via supervisory colleges.

- 3) Through the thorough fostering, securing and training of specialized human resources, the FSA will redouble efforts for human resource development and permeating financial knowledge.

2. Risk Management and Stability of Financial System

Although Japan's financial sector has maintained its health relative to its foreign counterparts, turmoil in the financial and capital markets at home and abroad and a weak real economy have started to have an impact on the profit-earning environment surrounding financial instruments business operators, etc., as shown by the financial statements of the securities companies for the fiscal period ending March 2009. Under these circumstances, in order to thoroughly continue performing a market intermediary function, it is essential that financial instruments business operators, etc. establish high-quality risk management. The FSA will pay particular attention to the following points, and will encourage autonomous efforts of every financial instruments business operator.

(1) Risk management systems for securities companies

- (i) The FSA will operate the early-warning systems introduced in April 2008 in an appropriate manner and obtain a comprehensive list table of the business models and the latest business conditions of the securities companies, which will be analyzed on a cross-industrial basis in a chronological order. If the analysis shows indications of the business experiencing difficulties, the FSA will attempt to get a grasp of the situation at an early date. In doing this, special attention will be paid to the impact of a downturn in business on liquidity management.
- (ii) In particular, securities companies engaged in large-scale and complicated businesses put the financial system at increased potential risk as a result of the concentration of risk on one hand, and of having difficulty in controlling business on a group-wide basis and in identifying where the risk lies in the group on the other hand. In supervising these securities companies, it is important to have a solid, complete, and comprehensive risk management system in place on a group basis under an appropriate framework of business management (governance), which will eventually make a contribution to the stability of the financial system. The FSA will, more rigorously than ever, verify the effectiveness of group-wide market risk management systems, customer risk management systems, and liquidity risk management systems for these securities companies, while increasing its risk sensitivity.
- (iii) As for the securities finance companies, the FSA will verify whether or not these companies

have an appropriate risk management system in place, particularly when they have become highly dependent on profit-making sources other than licensed business.

(2) Response to various funds

- (i) As for the collective investment schemes (funds) that have recently become an object of regulation under the Financial Instruments and Exchange Act (FIEA), the FSA will seek to understand their actual conditions to the maximum possible extent. For this purpose, the FSA will attempt to obtain more information about the true state of the so-called hedge funds in Japan, including those in the form of investment trusts.
- (ii) For J-REITs, the FSA will continue monitoring the status of fund-raising and encourage them to provide information to investors in an appropriate manner.
- (iii) From the perspective of the stability of the financial system, the FSA will also take notice of MRFs, which have become widespread as financial instruments that can be used as securities consolidated accounts, and MMFs, which have become widespread as financial instruments that can be deposited and withdrawn freely.

(3) Enforcing regulation on credit rating firms

Following the revision of the FIEA on June 2009, the FSA will try to enforce the regulation and supervision of credit rating firms in a smooth and appropriate manner under the framework of the registration system.

(4) Soundness of financial system

While responding to the above issues on a policy-by-policy basis, the FSA will also have a good prescience of issues by considering the state of transactions in financial and capital markets, while fully cooperating with the BOJ as well as by scrutinizing the state of risk accumulation and the distribution mechanism, from the viewpoint of being able to continually and stably develop the financial system as a whole.

3. Improving Customer Protection and Convenience for Users

Improving customer protection and convenience for users not only helps to achieve a sound national economy, but it also helps to stabilize Japan's financial systems by increasing citizens' trust in financial institutions and in financial and capital markets. In financial institutions, when having strict management of customer information and preventing people from abusing their position of power, and managing conflicts of interest, and also when having thorough customer protection based

on a sense of security and trust, it is important to make use of originality and ingenuity from the customer's viewpoint and increase competitiveness by providing financial products and services.

Accordingly, in this program year, the FSA will conduct investigations while placing priority on the following points, aimed at improvements by financial instruments business operators, etc. for customer protection and better convenience for users.

In doing this, the FSA will try to increase the transparency and predictability of the system operations lest the ambiguity of the treatment of such inventive instruments and services under the laws of Japan should impair the inventiveness of financial instruments business operators, etc. Further, the FSA will strive to have a high opinion of the independent efforts of financial instruments business operators, etc. and to give weight to incentives. Concurrently, the FSA will take into account whether financial instruments business operators are distortedly motivated by the pursuit of their short-term interests or by conflicts of interest.

Furthermore, as the need arises the FSA will cooperate with the Consumer Affairs Agency, an institution for which there is high hopes with regards to its fulfillment of roles in the area of integrated promotion of consumer administration.

(1) Solicitation and presentation

- (i) The FSA will encourage financial instruments business operators, etc. to operate while keeping in mind the viewpoints of customers so that they can establish long-lasting relationships with their customers and gain customers' trust and confidence. To this end, the FSA will check whether or not the financial instruments business operators have a system in place in which solicitation for and the presentation of financial instruments is made in an appropriate and flexible manner in accordance with the customers' experience levels and attributes. Particularly, this will be the case with regard to the solicitation for and presentation of risky financial instruments, such as investment trusts, structured products, derivatives, etc.
- (ii) The FSA will check the effectiveness of the systems employed by financial instruments business operators, etc. to deal with customers' complaints and consultation requests. Given that the FIEA as revised in June 2009 includes the creation of the Financial ADR System, the FSA will encourage financial instruments business operators, etc. to make themselves ready for the commencement of the system. Even prior to the commencement thereof, the FSA will check whether financial instruments business operators have in place an appropriate system to deal with complaints and requests for consultation from customers under the current framework of voluntary ADR systems driven by SROs.
- (iii) As for foreign exchange margin transactions, the FSA will make an effort to carry out the proposed actions, including a review of the sectional management of customers' assets (integration into cash trust), imposition of obligations to establish and observe loss cut rules,

and introduction of restrictions on margin deposits. In addition, the FSA will check the solicitation and presentation systems employed by low-spread foreign exchange traders. The FSA will also keep a watchful eye on the actual conditions of securities-based CFD trading.

- (iv) Given that, as a result of the review of the firewall regulations in June 2009, a framework has been created on the basis of the principle of encouraging financial institutions to voluntarily put in place a system for the control of conflicts of interest, the FSA will check whether or not the management divisions of financial institutions make voluntary efforts to increase the level of users' convenience and to control conflicts of interest.

(2) Internal control system (thorough management of information security)

- (i) Financial instruments business operators, etc. assume a public role as market intermediaries, and they are expected to have in place an adequate internal control system under an appropriate management (governance) system to ensure proper business operations by putting in motion check-and-balance functions across all departments. From this perspective, the FSA will check the actual conditions of financial instruments business operators.
- (ii) Among other things, customer information forms the basis of financial instruments transactions and the intermediation thereof, and so it also needs to be managed strictly from the viewpoint of protecting personal information. Furthermore, it is important to strictly manage corporate information in order to increase trust in market transparency and fairness. From these viewpoints, the FSA will examine whether management is making autonomous efforts for the maintenance of internal control systems for information security, and for the enhancement of rules of professional conduct to prevent inappropriate actions of officers (such as information leaks or insider trading).
- (iii) For financial instruments business operators, etc. that have been subject to administrative disposition, the FSA will check whether such operators have made improvements to their internal control systems in an appropriate manner.

(3) Ensuring business continuity

- (i) For financial instruments business operators, etc. that operate on customers' assets deposited with them, the FSA will respond to any indications of discontinuance of business due to deteriorating financial conditions with careful attention to the protection of customers' assets. For financial instruments business operators that do not operate with customers' assets deposited with them, the FSA will also deal with any information gained concerning the continuity of operations in an appropriate manner from the standpoint of client protection.
- (ii) Financial institutions' systems are essential infrastructure for running a business and as those systems become more advanced and complex, the effects that system failures have on customer

transactions are becoming larger and larger. In particular, given that instances of system failures at financial instruments business operators, etc. are occurring frequently, with regards to the continuity of systems, the FSA will confirm whether the financial instruments business operator is conducting appropriate risk management under the leadership and commitment of management personnel.

- (iii) The FSA will also confirm whether the financial instruments business operator is building a system with which it can ensure business continuity in the event of earthquakes or epidemics of new influenza viruses.

(4) Unregistered financial instruments business operators

- (i) There seems to be no end to the solicitation for unlisted shares and fraudulent solicitation for an interest in collective investment schemes (funds). In view of this, the FSA will respond to unregistered financial instruments business operators jointly with the police authorities. The FSA will appropriately deal with unregistered business operators located outside of Japan who solicit domestic investors for financial instruments.
- (ii) For registered financial instruments business operators, inadequate responses have also been found due to such a lack of staff that the proper performance of business under the registration system is hampered. The FSA will respond harshly to such activities of registered financial instruments business operators, etc. in accordance with the laws and regulations.