



# FSA Newsletter October 2007



Minister Watanabe had a meeting with Ms. Lianne Dalziel,  
Minister of Commerce of New Zealand (September 28)

## Table of Contents

### [TOPICS]

- "Towards Enhanced Market Integrity - Policy Statement of New SESC - " ..... 2
- Annual Report on the SESC's Activity ..... 4
- Status of Non-Performing Loans (NPLs) as of the end of March 2007 (Key Points) ..... 6

### [Guidelines for Supervision]

- "Guidelines for Supervision of Financial Instruments Firms, etc. for Program Year 2007" ..... 7
- "Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions" ..... 13
- "Guidelines for Supervision of Major Banks, etc. for Program Year 2007" ..... 15

## **"Towards Enhanced Market Integrity - Policy Statement of New SESC -"**

### **I . Introduction**

The Securities and Exchange Surveillance Commission (hereinafter referred to as "SESC") entered its sixth term under the new Board when Kenichi Sado was appointed as its new Chairman and Shinya Fukuda and Shozo Kumano were appointed as new Commissioners on July 20, 2007. The SESC on September 5 issued a policy statement "Towards Enhanced Market Integrity - Policy Statement of New SESC -" (hereinafter referred to as "Policy Statement"), which explains a basic concept of what the SESC intends to accomplish under the new Board.

This policy statement describes the SESC's medium-term strategy, which aims, in a comprehensive manner, to establish a market with enhanced integrity and transparency and to revitalize the Japanese market and to make it more competitive vis-a-vis overseas markets. Thus, this strategy conforms in various ways with the concept of better regulation advocated by the Financial Services Agency.

The outline of "New Directions" is as follows:

### **II . Outline of "the Policy Statement"**

#### **1. Missions**

The SESC is committed to achieving two objectives:

- ▶ **To ensure integrity of the capital market**
- ▶ **To protect investors**

#### **2. Directions of new SESC**

The Japanese capital market has been experiencing dynamic changes. New and more complex financial products and transactions continue to develop under fast moving capital flows across countries. The regulatory environment has also evolved to address such changes in the markets, including the introduction of the Financial Instruments and Exchange Act in September 2007. Noting the rapidly changing market environment, the SESC is determined to make its best efforts as a market regulator, setting out the following directions:

##### **(1) Timely and comprehensive oversight with a more strategic focus**

- ▶ Prompt and effective market oversight by strategically adopting the best mix of regulatory tools endowed to the SESC, including daily market surveillance, inspection of regulated entities, administrative monetary penalty investigation, disclosure document inspection and criminal investigation
- ▶ Proactive oversight for potential risks on top of current market misconduct
- ▶ Enhanced cooperation with Self Regulatory Organizations (SROs) and overseas regulators in order to achieve effective market oversight across marketplaces

##### **(2) Collaboration with stakeholders for market integrity**

- ▶ Contribution to rule-making processes by the FSA and other relevant authorities, reflecting challenges

identified through market oversight by the SESC

- ▶ Enhancement of self-regulatory functions of SROs
- ▶ Outreach to market participants to encourage their self-discipline for market integrity
- ▶ Closer dialogue and communication with market participants

We believe that effective market oversight by the SESC and a consequent high level of market integrity are essential for the Japanese capital markets to remain active and competitive in global marketplaces.

### **3. Policy Focus**

The SESC is determined to strategically mobilize its regulatory tools and resources, with particular emphasis on the following, in order to conduct effective and efficient market oversight:

#### **(1) Comprehensive and timely market oversight**

- ▶ Seamless oversight of both primary and secondary markets
- ▶ Extensive surveillance of suspicious transactions
- ▶ Analysis of backgrounds behind individual cases and market developments to help provide timely market oversight

#### **(2) Enhanced use of administrative monetary penalty system**

- ▶ Further exploitation of administrative monetary penalty system to expeditiously address market misconduct

#### **(3) Implementation of the Financial Instrument and Exchange Act**

- ▶ Expansion of the scope of inspection to cover collective investment schemes and quarterly corporate disclosure
- ▶ Increased focus on internal control and governance of regulated entities

#### **(4) Enhanced cooperation with SROs**

- ▶ Further cooperation with SROs in areas including oversight of member firms and rule making, as well as outreach to market participants

#### **(5) Enhanced cooperation with overseas regulators**

- ▶ Further cooperation with overseas regulators, including proactive information exchange as well as surveillance of electronic trading, thus precluding any gaps in market oversight

In addition, "New Directions" sends out the following message to market participants:

"The SESC alone cannot secure integrity of the market; individual market participants' effort is crucial. Let us work together to enhance integrity of the capital market for everyone to participate with comfort."

### **III. Conclusion**

The SESC intends to do its utmost to ensure the integrity of the market and protect investors by effective market oversight based on the above-explained "New Directions."

\*You can access the text of "[Towards Enhanced Market Integrity - Policy Statements of New SESC - \(New Directions\)](#)" in the Press Release section of the SESC's Web site.

## Annual Report on the SESC's Activity

### 1. Introduction

The Securities and Exchange Surveillance Commission (SESC) is required to publish an annual report on its activity under the Article 22 of the Act for Establishment of the Financial Services Agency. In line with this requirement, the SESC published its annual report for the period from July 1, 2006 to June 30, 2007 (Business Year 2006 on August 31, 2007). This was the 15th such report to be issued by the SESC since its establishment.

### 2. Outline

In order to promote investment by encouraging a shift from "savings to investment," it is essential to establish a sound securities market endowed with enhanced integrity and transparency, and to maintain investors' trust in the market. In this context, the SESC's market oversight functions have been expanded and strengthened. In particular, the scope of the SESC's inspections was significantly expanded in 2005 as the SESC, which already had the authority to conduct criminal offense investigations and inspections of securities companies, etc. to examine whether they ensured the integrity of transactions, was delegated to exercise authority over the newly introduced administrative monetary penalties investigations and disclosure document inspections, as well as inspections of securities companies, etc. to examine the soundness of their financial conditions, and inspections of investment trust management firms and investment advisory firms, etc. Furthermore, business operators engaged in foreign exchange margin trading were newly designated as financial futures trading firms, subject to inspection by the SESC. Based on this significantly expanded authority, in Business Year 2006 the SESC conducted not only criminal offense investigations and inspections of securities companies to examine whether they ensured the integrity of transactions, but also a broader range of investigations and inspections.

#### (Filing Formal Complaints and for Unfair Trading)

The number of complaints filed in relation to illegal transactions totaled 12, the highest annual figure since the establishment of the SESC. Based on the advance of IT (information technology) has facilitated such activities, as information can be communicated and orders placed through the Internet wherever business operators and customers may reside. This situation has increased the risk of the Internet being used to conduct illegal market activities such as insider trading and market manipulation. Therefore, the SESC has kept a nationwide surveillance net to detect illegal transactions, and collaborated with local investigative authorities. This led the SESC to file complaints against cases of serious and malicious criminal offences that have shaken the public trust in the securities market. These included a case of insider trading by an employee of a newspaper publishing company who was in charge of overseeing legally designated public notices (which involved shares in Nishimatsuya-Chain Co., Ltd. and four other companies), and a case of insider trading by executive officers, etc. of a corporation that had undertaken the work of compiling disclosure documents relating to important matters on a contract basis (which involved shares in Homac Corp. and another company).

Regarding recommendations relating to illegal transactions, the SESC recommended the issuance of an order

for the payment of an administrative monetary penalty in nine cases (all of which concerned insider trading). These included a case wherein the SESC recommended the issuance of an order for a listed company to pay a large administrative monetary penalty for purchasing its own shares before the announcement of an important matter, which was deemed to constitute an act of insider trading. The SESC's recommendations have prompted listed companies to implement measures to prevent insider trading, such as reviewing and revising their internal rules and internal control systems.

#### **(Formal Complaints and Recommendations for Disclosure)**

Regarding disclosure-related actions, the SESC filed a complaint against the submission of a false financial statement in one case involving three persons (the case of Sanbishi Co., Ltd.), for violation of the Securities and Exchange Law, as a result of a criminal offense investigation.

In addition, the SESC recommended the issuance of an order for the payment of an administrative civil monetary penalty (the case of falsification of a financial statement of Higashinihonhouse Co., Ltd.) for the first time in November 2006 as a result of a disclosure document inspection, and made the same recommendation in four other cases of falsification of disclosure documents. In addition, the SESC recommended the issuance of an order for the submission of a corrected financial statement in one case. In one of the aforementioned cases, the SESC recommended that Nikko Cordial Corporation. should be ordered to pay an administrative civil monetary penalty in relation to its falsification of a supplementary document regarding shelf registration, and this case increased public interest in disclosure.

#### **(Inspection of Securities Companies and Other Entities)**

The SESC completed 209 inspections, the highest number since its establishment, and recommended administrative disciplinary actions against 28 companies out of the 142 companies regarding which the SESC found problems. Particularly notable is that the SESC inspected Self-Regulatory Organizations (SROs) in Business Year 2006 from the viewpoint of whether their self-regulatory activities were sufficiently effective and whether their functions were properly exercised, and recommended administrative disciplinary actions against 3 organizations whose market oversight was deemed to be deficient.

#### **(Policy Proposals)**

Between its establishment in 1992 and Business Year 2005, the SESC presented a total of 12 policy proposals. In Business Year 2006, it presented 3 policy proposals to the FSA Commissioner. These concerned pre-underwriting examination, regulations on transactions distorting market indices, and revision of retention periods for statutory books.

#### **(Market Surveillance)**

The SESC received a total of 6,485 pieces of information from the general public such as investors in Business Year 2006.

Meanwhile, the number of oversight cases handled by the SESC in Business Year 2006 totaled 1,039, which represented the highest figure since the establishment of the SESC in 1992, and a rise of about 20% from the

previous business year.

Furthermore, in response to an increase in cross-border transactions the SESC is endeavoring to maintain close cooperation with overseas securities regulatorys. As a result of such cooperation in Business Year 2006, there were two cases wherein overseas securities regulatorys took disciplinary actions, based on what was detected as a result of the SESC's oversight activities.

### **Status of Non-Performing Loans (NPLs) as of the end of March 2007 (Key Points)**

On August 9, 2007, the Financial Services Agency announced the status of non-performing loans at Japanese banks as of the end of March 2007.

The key points of the status are as described below.

The total amount of NPLs at all Japanese banks, based on the definition set by the Financial Reconstruction Act, stood at 12.0 trillion yen as of the end of March 2007, down 1.4 trillion yen from 13.4 trillion yen as of the end of March 2006.

The NPL ratio (see note below) as of the end of March 2007 declined from the end of March 2006 for both major banks and regional banks and for Japanese banks as a whole,, dropping to the lowest levels since the disclosure of NPLs based on the Financial Reconstruction Act started in 1999 (with the first disclosure covering the figures for the end of March 1999).

Note: NPL rate (=NPLs (based on the Financial Reconstruction Act)/total loan amount)

	March 2005	March 2006	March 2007
Major Banks	2.9%	1.8%	1.5%
Regional Banks	5.5%	4.5%	4.0%
All Banks	4.0%	2.9%	2.5%

Particularly notable is that the NPL rate for major banks declined an additional 1.4 percentage points to 1.5% after these banks had achieved the goal of halving the NPL rate (see note below) under the Program for Financial Revival (October 2002), by lowering it to 2.9% as of the end of March 2005.

Note: The Program for Financial Revival set the goal of reducing the major banks' NPL rate of 8.4% as of the end of March 2002 to around half that figure by the end of fiscal 2004 (the end of March 2005).

Furthermore, the NPL rate for regional banks as a whole has steadily declined as these banks made progress in strengthening their functions regarding regionally-focused finance (relationship banking).

The FSA will continue to ensure appropriate supervision of financial institutions in order to prevent the bad loan problem from arising again and dragging down the Japanese economy.

\* For details, please access the FSA's Web site and go to ["Status of Non-Performing Loans"](#) in the "Regulated

**[Guidelines for Supervision]**

**“Guidelines for Supervision of Financial Instruments Firms, etc. for Program Year 2007”**

On August 24, 2007, the Financial Services Agency announced the “Guidelines for Supervision of Financial Instruments Firms, etc. for Program Year 2007.” The guidelines for supervision set forth major points of examination in conducting supervision during the relevant program year, with a view to improving the transparency of financial administration and making it easier for regulated institutions to foresee how financial regulation will be conducted. The FSA formulated the annual guidelines for the first time in Program Year 2005, and the new guidelines are the third of its kind. Although the first guidelines were intended exclusively for supervision of securities companies, the scope of the second guideline was expanded to cover financial futures trading companies and investment trust management companies, in addition to securities companies. In line with the full enforcement of the Financial Instruments and Exchange Act on September 30, the new, third guidelines cover a broad range of financial instruments firms, including those engaged in collective investment schemes, as well as registered financial institutions. The outline of the new guidelines are as follows.

**I. Basic Approach**

In the Japanese financial sector, which depends excessively on indirect financing, it is essential not only to stimulate Japanese financial and capital markets, whose international presence is diminishing, and enhance their international competitiveness, but also to shift the emphasis of financing to direct financing and indirect market financing: in other words, to accelerate the shift of funds “from savings to investments.”

Meanwhile, improvement has been made with regard to the three major areas of financial administration—namely, the stability of the financial system, customer protection and the establishment of fair and transparent markets—due to the progress made in the establishment of the relevant frameworks. In this context, self-help efforts by financial institutions are becoming more important than ever before.

Against this backdrop, one of the major challenges in financial administration is to improve the quality of financial regulation, namely to achieve “better regulation.”

To that end, it is necessary to make efforts in terms of supervision methods with respect to the four matters listed below. Accordingly, the FSA shall strive to (1) enhance dialogue with financial instruments firms, etc., (2) enhance the dissemination of information from the FSA, (3) enhance cooperation with foreign authorities, (4) accurately identify market trends through the enhancement of market research functions, and (5) improve the quality of FSA staff.

- (1) Optimal combination of rules-based and principles-based supervisory approaches
- (2) Responding to high-priority issues through effective use of regulatory resources
- (3) Placing greater emphasis on incentives for financial instruments firms, etc. and encouraging self-help efforts
- (4) Enhancing the transparency of regulatory actions

**II. Key Issues**

In the guidelines for supervision for the current program year, the issues that were previously taken up on a theme-by-theme basis have been brought together into the section entitled “Supervision of Financial Instruments Firms,” and are positioned as key issues common to all types of financial instruments firms. Key issues are also set forth for each of the business types, from Type I financial instruments businesses to investment advisory and management businesses. Furthermore, as a supplement, the guideline sets forth issues relating to funds and registered financial institutions, as well as unregistered/unlicensed firms. Explanations with regard to each business type are provided below:

## **1. Supervision of Financial Instruments Firms**

### **(1) Ensuring Appropriate Business Operation Systems and Staffing**

The first key issue common to all types of financial instruments firms is to ensure an appropriate system for business operations and appropriate staff. This is an issue to be considered when firms are screened for registration.

It is necessary to implement procedures for registering financial instruments firms promptly and smoothly, so that the registration process does not disrupt the continuity of operations that have been conducted by the applicant since before the enforcement of the Financial Instruments and Exchange Act. At the same time, it is necessary to ensure that the registration process is rigorously implemented so as to exclude ineligible firms that are problematic from the viewpoint of customer protection.

To that end, when screening firms for registration as financial instruments businesses, the FSA shall examine, for example:

- whether the applicants have staff suited for appropriate execution of financial instruments business in light of the registration screening criteria set by the guideline for supervision, and the records on relations with organized crime groups and members of such groups and on criminal punishments incurred.
- whether those applicants that have no plans to join the Financial Instruments Firms Association or become members or trading participants of a financial instruments exchange have formulated appropriate internal rules with due consideration of the rules set by the association, etc.

### **(2) Development of Advanced and Robust Compliance and Risk Management Systems**

In order for financial instruments firms to operate their businesses in a sound and appropriate manner based on a high standard of self-discipline, it is necessary for the firms’ management teams first to have heightened awareness of compliance and become actively involved in efforts to secure company-wide compliance. In addition, it is important for the compliance department and the risk management department to properly fulfill their respective functions. The FSA shall examine these points in inspections.

### **(3) Customer Protection**

The Financial Instruments and Exchange Act categorizes investors into two classes—professional investors and non-professional investors—with a view to maintaining the balance between protecting customers properly and facilitating the supply of risk capital. It stipulates that, in cases where a financial instruments firm conducts a transaction with a non-professional investor, a sufficient code of conduct shall be applied from the viewpoint of

customer protection, whereas in cases where the firm conducts a transaction with a professional investor, many provisions of the code of conduct may be waived.

Based on the above-mentioned stipulation, the FSA, as part of a rules-based approach, shall examine whether financial instruments business firms screen investors appropriately so as to separate them into professionals and non-professionals, whether they solicit customers and provide explanations in an appropriate manner and in compliance with the suitability rules, and whether they comply with new regulation on advertisements.

Furthermore, the FSA shall, as part of a principles-based approach, examine financial instruments firms' systems for screening investors to separate them into professionals and non-professionals, verifying the appropriateness of the screening results, ensuring compliance with the suitability rule, screening advertisements and handling customer complaints.

As financial instruments become increasingly sophisticated and complex and a succession of new products are released, it is impossible to establish detailed customer protection rules preemptively for all types of financial instruments. Therefore, it is important for each financial instruments firm to develop appropriate systems and make voluntary efforts to protect customers, based on the principles set forth by laws and regulations. The FSA shall examine the development status of customer protection systems while respecting such voluntary efforts.

#### (4) Customer Information Management

In principle, multiple businesses can be operated based on a single registration following the enforcement of the Financial Instruments and Exchange Act, and this is expected to promote the diversification of financial instruments firms' operations. In this situation, the FSA shall keep a close watch on whether or not any personal information or customer information, including corporate information, has been leaked, lost or impaired—in particular, whether or not such information is shared improperly between groups—and, as necessary, take supervisory action based on the Financial Instruments and Exchange Act, the Personal Information Protection Act, etc.

#### (5) Governance of Financial Conglomerates

As financial conglomeratization proceeds and the operations of financial instruments firms become more diverse, the FSA shall examine whether corporate groups that include financial instruments firms are endeavoring to eliminate potential conflicts of interest, to prevent concentration of risks and to ensure the appropriateness of intra-group transactions.

## **2. Supervision by Business Type**

### (1) Type I Financial Instruments Businesses

In supervising Type I financial instruments firms, the FSA shall examine the status of compliance with new regulation on advertisements by securities companies and compliance with the ban on unsolicited calls by firms engaged in foreign exchange margin trading, which remained a problem in the previous program year.

Furthermore, the FSA shall examine the status of compliance with self-imposed rules formulated by

industry associations based on the "Summary of Issues" published by the Round Table Conference on the Financial Market Intermediation Function of Securities Companies and, in the case of firms engaged in investment banking and principal investment, pay attention to the system for preventing conflicts of interest.

(2) Type II Financial Instruments Businesses

Regarding Type II financial instruments businesses, the FSA shall pay attention to the system of firms engaged in the sale/solicitation of rights to interests in so-called collective investment schemes (funds) for providing explanations. It is deemed that such firms include those which were not subject to supervision by the FSA prior to the enforcement of the Financial Instruments and Exchange Act and those which deal in funds with limited transparency and liquidity, regarding which it is extremely difficult for investors to grasp the actual state and judge the value.

(3) Investment Management Businesses

Regarding investment management businesses, the FSA shall pay supervisory attention to whether or not firms have established a proper business execution system concerning administration and management of assets and execution of trades, and whether or not they employ misleading representations using simulations based on arbitrary assumptions, for example. With respect to firms engaged in real estate fund investment businesses, in particular, it is necessary to pay due consideration to changes occurring in the market and business environment, such as the real estate market's increasing correlation with the financial market (integration of real estate into financial instruments) and with overseas markets (globalization), and the expanding supply of risk money. In order to ensure that the pricing function is exercised appropriately under these conditions, the FSA shall implement necessary examination and take necessary supervisory actions with respect to systems for conducting due diligence upon the acquisition and sale of real estate and systems for preventing transactions involving conflicts of interest. Meanwhile, it is necessary to bear in mind that such supervision is not intended to affect the prices of individual real estate assets.

(4) Investment Advisory/Agency Businesses

Regarding investment advisory and agency businesses, the FSA shall examine whether or not firms employ misleading advertising practices, such as making unsubstantiated representations describing their track record of investment advice as substantially superior, and take necessary supervisory actions.

### **3. Matters Requiring Special Attention with Regard to Funds**

The guideline for supervision for the current program year sets forth matters requiring special attention with regard to "funds" in particular, as they have attracted attention recently due to discussions about them by the G-7 countries and their corporate acquisitions.

On the one hand, funds are expected to help establish markets that have "depth," promote financial innovation and internationalize Japanese financial and capital markets by performing their diverse range of functions in an appropriate manner. On the other hand, however, they are deemed to involve specific potential risks. Therefore, with due consideration of the discussions conducted at international conferences, the FSA shall

monitor firms that deal in foreign funds that have no investors in Japan—for example, in ways to ensure appropriate risk management by the counterparty (e.g., a financial instruments firm that happens to be the other party to the transaction) —and secure the fairness and transparency of the market, while keeping a close watch on general trends and industry moves to review and improve business practices.

On the other hand, with respect to firms that deal in funds subject to supervision and mandatory registration or notification, the FSA shall conduct supervision properly after fully grasping their actual state from the viewpoint of customer protection, etc.

As indicated above, it is necessary for the FSA to identify as quickly as possible where funds' risks exist in light of the type of investment management, and allocate supervisory resources accordingly.

The guideline for supervision requires that a monitoring survey be conducted on fund management firms subject to supervision and mandatory registration or notification with respect to (1) the name of fund, (2) the type of fund, and (3) the total amount of invested assets. It is important to identify the general trends through such surveys. The FSA will take advantage of this opportunity to engage in dialogue with the firms concerned, constantly keep track of, investigate and analyze the actual state of the industry and take action preemptively, in anticipation of the future materialization of risks.

#### **4. Supervision of Registered Financial Institutions**

In supervising registered financial institutions, the FSA shall pay attention to whether or not financial institutions ensure the prevention of abuse of superior positions and examine their systems for prevention, in anticipation of their moves to handle over-the-counter derivatives transactions. Furthermore, the guideline for supervision calls for attention to whether financial institutions take steps to prevent customers from mistaking investment trusts and similar products for deposits and the like, and whether they deal with customers in a sincere manner in relation to any inappropriateness involved in a transaction.

In addition, the FSA shall examine the management of information to prevent inappropriate information exchange between the department that handles credit derivatives transactions and the loan department, and the effectiveness of measures for preventing conflicts of interest.

#### **5. Handling of Unregistered/Unlicensed Entities**

Some of the entities that were not covered by the previous regulatory framework based on laws governing individual business sectors are expected to continue their business operations without registering or filing a notice with the authorities, either intentionally or through negligence, after the enforcement of the Financial Instruments and Exchange Act. If such entities are identified as a result of customer complaints, inquiries, etc., the FSA shall warn them in writing or through other means to immediately suspend the activities in question. In the case of entities operating without registering or filing a notice with the authorities through negligence, the FSA shall have them apply for registration or file a notice promptly under the Financial Instruments and Exchange Act.

With regard to entities intentionally refusing to register or file a notice and entities acting maliciously in other ways, the FSA shall immediately contact the law enforcement authorities, etc. and take measures to prevent damage to customers from arising and spreading.

### **III. Supervisory Method**

The "Supervisory Method" section of the new guideline for supervision includes references to the supervisory department's cooperation with the inspection department, self-regulatory organizations and foreign supervisory and regulatory authorities, as well as its relations with financial instruments business firms.

Regarding cooperation with self-regulatory organizations in particular, the new guideline sets forth four new issues.

- (1) First, the FSA shall continue to follow up on the implementation of measures such as the formulation of self-imposed rules based on the "Summary of Issues" published by the Round Table Conference on the Financial Market Intermediation Function of Securities, and seek cooperation in examining the status of financial instruments firms' compliance with the rules.
- (2) Secondly, the FSA shall follow up on the implementation of measures by the five relevant industry associations based on the "Interim Summary of Issues on the Status of Financial Instruments Firms Association," which was drawn up by the associations with due consideration of the importance of achieving the purpose of the Financial Instruments and Exchange Act—that is, to ensure thorough enforcement of the cross-sectoral rules concerning investor protection, at the level of self-imposed regulation as well, as part of efforts to improve the quality of regulation—and shall provide necessary cooperation.
- (3) Thirdly, the FSA shall pursue appropriate cooperation with other entities in order to exclude organized crime groups, etc. from financial instruments businesses; for example, by using the Securities Safeguard Liaison Council as a conduit to work with the relevant organizations.
- (4) Lastly, with regard to certified investor protection organizations, the FSA shall establish the certification criteria and determine other necessary matters and implement proper measures so as to ensure that the certification system functions effectively from the viewpoint of customer protection.

In dealing with financial instruments firms, etc., it is important for the FSA to actively engage in dialogue with them in order to promote mutual understanding, enhance the dissemination of information from the FSA and the ability to identify market trends, and improve the transparency and predictability of regulatory actions.

Particularly notable is that upon the enforcement of the Financial Instruments and Exchange Act, the FSA is authorized to issue orders for financial instruments firms, etc. to change the method of their business, only to the necessary extent, in cases where it is deemed necessary and appropriate for the public interest and for the purpose of protecting investors, even if the firms are not necessarily violating laws and regulations, etc.

The management teams of financial instruments firms, etc. are required to ensure appropriate internal control with due consideration of the fundamental philosophy of the laws and regulations and the purpose and objective of the regulations. Therefore, the FSA shall exchange opinions with the management teams, etc. of financial instruments firms, etc. to a sufficient degree on such matters and examine the effectiveness of the management teams' internal control, while respecting their voluntary efforts to ensure appropriate internal control.

## **“Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions for Program Year 2007”**

Since Program Year 2004, the Financial Services Agency (FSA) has made it a custom to adopt and publish a guidelines for the supervision of small- and medium-sized and regional financial institutions at the beginning of each program year, so as to clarify key supervisory issues.

In the current program year, the FSA on August 24 adopted and published the “Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions for Program Year 2007,” in order to show its basic approach to supervision and key supervisory issues. The outline of the new guideline is explained below.

### **1. Basic Approach**

#### **(1) Improvement in Quality of Supervision**

Revitalizing the Japanese financial and capital markets and making them more competitive against foreign markets is a priority policy issue for Japan. In this context, the quality of Japan’s financial regulation and supervision, which is a decisive factor for the competitiveness of the markets, faces a new test.

With due consideration of this financial administration situation, the FSA intends to improve the quality of supervision by implementing measures to tackle the following four issues:

- 1) Achieving optimal combination of rules-based and principles-based supervisory approaches
- 2) Responding to high-priority issues through effective use of regulatory resources
- 3) Placing greater emphasis on incentives for financial institutions and encouraging self-help efforts
- 4) Enhancing the transparency and predictability of regulatory actions

When implementing such measures, the FSA will endeavor to enhance dialogue with financial institutions, enhance the dissemination of information from the FSA, accurately identify market trends through the enhancement of market research functions, and improve the quality of FSA staff, thereby ensuring the effectiveness of the measures.

#### **(2) Key Issues**

In light of a shift to a permanent framework for the promotion of regionally focused finance, or relationship banking, and the enforcement of the Financial Instruments and Exchange Act in September, as well as the diversification and increasing complexity of financial instruments and investment assets handled by small- and medium-sized and regional financial institutions, the FSA will focus on the following three key issues in order to improve the quality of supervision in the current program year:

- 1) Promotion of relationship banking
- 2) Thorough protection of regional users and improvement in user convenience
- 3) Establishment of risk management systems suited to risk profiles

At the same time, the FSA will endeavor to conduct rigorous and effective regulation and supervision in an efficient manner.

It should be noted that the FSA will pay particular supervisory attention to whether the management team

exercises its leadership in order to ensure appropriate governance under the principle of self-responsibility. At the same time, the FSA will continue to enhance cooperation with the inspection departments and with Local Finance Bureaus and other entities that are directly in charge of supervising financial institutions.

## **2. Details of Key Issues**

### **(1) Promotion of Relationship Banking**

The first key issue is the promotion of relationship banking.

The FSA decided to continue the promotion of relationship banking under a new permanent framework in line with the guideline for supervision that was revised based on a report issued in April by the Financial System Council. The FSA regards this as the first key issue of the year because the current program year marks the starting year of the new framework.

Under the new framework, the FSA will follow up on the three issues listed below because these issues were described by the Financial System Council's report as matters essential to relationship banking and also because a user questionnaire survey revealed that measures taken with regard to these issues are deemed to be insufficient.

It should be borne in mind that individual financial institutions should be left to decide what specific measures to take with regard to these issues, from the viewpoint of respecting their independence.

- 1) Enhancing support for borrower companies in a manner suited to their corporate life cycle
- 2) Ensuring the adoption of fund supply methods suited to small- and medium-sized companies
- 3) Making sustainable contributions to regional economies

### **(2) Thorough Protection of Regional Users and Improvement in User Convenience**

The second key issue is thorough protection of regional users and improvement in user convenience.

The FSA has decided to maintain its focus on this issue in light of the enforcement of the Financial Instruments and Exchange Act and the diversification and increasing complexity of financial services handled by financial institutions. Particular emphasis will be placed on the following matters:

- 1) Expanding and enhancing systems for providing explanations to customers and handling customer inquiries and complaints
- 2) Ensuring compliance with laws and regulations
- 3) Enhancing and thoroughly implementing measures to prevent financial crimes and ensuring appropriate handling of customers
- 4) Establishing a customer information management system
- 5) Ensuring the appropriateness of the system for managing computer system risks
- 6) Ensuring appropriate business operations at entities using outsourcing.

### **(3) Risk Management Systems, etc. Suited to Risk Profiles**

The establishment of risk management systems, etc. suited to risk profiles is positioned as the third key issue.

This means that the FSA will continue to focus attention on the following matters when examining whether

financial institutions have established appropriate risk management systems and improved them in light of major risk scenarios reflecting factors such as the growth in asset management conducted through a variety of funds and other products with complex risk profiles, as well as interest and market trends:

- 1) Securing the reliability of asset assessment and credit risk management
- 2) Establishing a market risk management system
- 3) Ensuring adaptation to the Basel II regime

With regard to the market risk management referred to in 2), it is stipulated that, in line with the Comprehensive Guideline for Supervision of Small- and Medium-Sized and Regional Financial Institutions that has recently been revised, the FSA shall examine whether Shinkin Banks and credit cooperatives in particular, when investing in financial products with complex risk profiles, set risk limits at appropriate levels in relation to the capital size and whether, in the course of their decision-making process, they fully recognize and confirm the target of the investment, its risk profile, the risk-return relation, etc. by seeking sufficient explanations from entities selling the financial products.

Based on the guideline for supervision as described above, the FSA will continue to endeavor to improve the quality of supervision of small- and medium-sized financial institutions and conduct rigorous and effective supervision in an efficient manner in the current program year.

### **“Guidelines for Supervision of Major Banks, etc. for Program Year 2007”**

The Financial Services Agency (FSA) endeavors to conduct supervision in a highly transparent way by clarifying its basic approach and key points of attention in supervising major banks, etc. in a guideline adopted and published at the beginning of each program year.

In the current program year, the FSA on August 24 adopted and published the “Guideline for Supervision of Major Banks, etc. for Program Year 2007,” in order to show its basic approach to supervision and key supervisory issues. The outline of the new guideline is explained below.

#### **1. Basic Approach**

##### **(1) Improvement in Quality of Supervision**

In conducting financial administration, it is necessary for the FSA to strengthen and make more sustainable measures to resolve the bad-loan problem and enhance protection of users. In addition, revitalizing the Japanese financial and capital markets and making them more competitive against foreign markets is a priority policy issue. In this context, the quality of Japan’s financial regulation and supervision, which is a decisive factor for the competitiveness of the markets, faces a new test.

With due consideration of this financial administration situation, the FSA intends to improve the quality of supervision by implementing measures to tackle the following four issues:

- 1) Achieving optimal combination of rules-based and principles-based supervisory approaches

- 2) Responding to high-priority issues through the effective use of regulatory resources
- 3) Placing greater emphasis on incentives for financial institutions and encouraging self-help efforts
- 4) Enhancing the transparency and predictability of regulatory actions

When implementing such measures, the FSA will endeavor to enhance dialogue with financial institutions, enhance the dissemination of information from the FSA, strengthen cooperation with foreign authorities, accurately identify market trends through the enhancement of market research functions, and improve the quality of FSA staff, thereby ensuring the effectiveness of the measures.

## (2) Key Issues

A look at the situation surrounding major banks, etc. shows that they face a variety of changes, such as the enforcement of the Financial Instruments and Exchange Act in September, the diversification and increasing complexity of financial instruments and investment assets handled by the banks, and the growing trend of financial conglomeratization. Therefore, the FSA will focus on the following three key issues to improve the quality of supervision in the current program year:

- 1) Thorough user protection and improvement in user convenience
- 2) Risk management systems, etc. suited to risk profiles
- 3) Response to conglomeratization and globalization

At the same time, the FSA will endeavor to conduct rigorous and effective regulation and supervision in an efficient manner.

## 2. Details of Key Issues

### (1) Thorough User Protection and Improvement in User Convenience

The first key issue is thorough user protection and improvement in user convenience.

The FSA has decided to continue to focus on this issue as it takes account of the fact that major banks, etc. are required to make further efforts to protect users based on the enforcement of the Financial Instruments and Exchange Act, while providing financial services that satisfy the needs of customers, and that the need is growing for measures to prevent the abuse of financial services by organized crime groups. Particular supervisory attention shall be paid to the following matters:

- 1) Expanding and enhancing systems for providing explanations to customers and handling inquiries and complaints
- 2) Enhancing and thoroughly implementing measures to prevent financial crimes and ensuring appropriate handling of customers
- 3) Ensuring the appropriateness of the system for managing computer system risks.
- 4) Establishing and improving systems for ensuring the appropriateness of business operations
- 5) Establishing and improving screening and loan management systems suited to borrowers' needs
- 6) Ensuring appropriate business operations at entities using outsourcing
- 7) Implementing measures to prevent money laundering, etc.

## (2) Risk Management Systems Suited to Risk Profiles

The second key issue is the establishment of risk management systems suited to risk profiles.

As the implementation of appropriate risk management through voluntary and sustained initiatives by the management team is essential for maintaining the soundness of the financial conditions of a financial institution, the FSA will examine whether each financial institution's risk management system reflects changes in the nature of the business and in the business and market environment, and conduct debate as to what degree major banks, etc. understand major risk scenarios and how their management teams are responding thereto. Supervisory attention shall be paid to the following matters:

- 1) Whether the bank conducts business operations with due consideration of the risk-return relation
- 2) Whether and how the bank is responding to the diversification of investment assets
- 3) Whether and how the bank is improving the quality of its capital
- 4) Whether and how the bank is responding to the introduction of the Basel II regime.

## (3) Response to Conglomeratization and Globalization

The third key issue is response to conglomeratization and globalization.

Taking account of the growing trend of conglomeratization and the expansion of major banks' foreign operations, the FSA has decided to pay supervisory attention to whether the banks' headquarters appropriately maintain control of branches and foreign operations within their groups, and to seek close cooperation with foreign authorities as necessary. Specifically, attention shall be paid to the following matters:

- 1) Response to conglomeratization
- 2) Response to globalization
- 3) Improvement in the quality of supervision from the viewpoint of facilitating the globalization of the Japanese financial and capital markets.

Based on the guideline for supervision described above, the FSA will continue to endeavor to improve the quality of supervision of major banks, etc. and conduct rigorous and effective supervision in an efficient manner in the current program year.