

April 6, 2010

Securities and Exchange Surveillance Commission

Basic Inspection Policy and Inspection Program for Business Year 2010

I. Basic Inspection Policy

1. Basic Concept

The mission of the Securities and Exchange Surveillance Commission (SESC) is to ensure the fairness and transparency of the Japanese markets and to protect investors. Inspection is an important means to achieve this mission by examining the status of the business operations and assets of financial instruments firms, who act as market intermediaries.

In recent years, the regulatory environment surrounding the SESC's inspection has changed considerably.

As a result of a series of regulatory reforms, including the effectuation of the Financial Instruments and Exchange Act, the scope of business operators subject to the SESC's inspection has been expanded to include those engaging in the solicitation for and management of interests of collective investment schemes (investment funds) and credit rating agencies, leading to a sharp increase in the number of business operators subject to inspection to around 8,000 firms.

In order for the SESC to achieve its mission under these circumstances, it is essential to conduct efficient and effective inspection. From this perspective, the SESC shall collect and examine a variety of information concerning the business operators subject to the SESC's inspection while taking account of the size and risk profile of each business type and business operator, and of the market conditions at the time, and to prioritize business operators to be inspected based on the status of risks. The SESC shall also sharpen the focus of inspection and adapt the inspection techniques and the way of notifying the inspected business operators of the inspection results to a sharp-focus approach.

The current global financial crisis has reminded the regulatory authorities around the

world of the importance of ensuring the soundness of the financial position of globally active financial instruments firms. In light of this, when inspecting financial instruments firms that occupy an important position in the market, it is also necessary to place emphasis on the examination of the soundness of their financial position and the appropriateness of their risk management systems from the viewpoint of preventing them from falling into a management crisis.

The advance of IT systems in recent years has enabled investors to have access to computer systems that process a large volume of diverse orders at high speed, through the internet and other means and to sell and buy various financial instruments. As a result, the participation of individual investors in financial instruments transactions has increased remarkably, and the execution of massive and complex transactions by institutional investors is also spreading. Thus, these situations make it more important than ever to ensure the reliability of IT systems, which constitute the infrastructure of financial transactions. Therefore, when conducting inspection, the SESC needs to focus on the examination of the IT operational risk management system as well.

As described above, while the SESC's inspection needs to be adapted to changes in the surrounding situation, including institutional reforms implemented in recent years, it is also necessary to continue efforts to enhance both the examination as to whether there are any violations of laws and regulations as well as that of the internal control system in relation to specific problems so as to ensure the fairness of transactions, which is a basic objective of the inspection. Financial instruments firms are supposed to conduct business operations in accordance with laws and regulations as well as market rules so as to ensure an environment in which investors can make investment with a sense of security. The SESC will maintain a strict stance toward activities which violate laws and regulations and undermine the reliability regarding the fairness and transparency of the Japanese markets when conducting inspections, and will continue to sound an alarm necessary for the market.

2. Implementation Policy of Inspection

(1) Toward efficient and effective inspection

1) Inspection focused on risks

When prioritizing business operators to be inspected, the SESC will analyze

information collected from a wide range of sources, including supervisory authorities, and will take account of their positions in the market and their inherent problems in a comprehensive manner. In addition, in cases where cross-sectional issues related to the financial and capital markets have been identified, the SESC will conduct special inspection with a cross-cutting theme (a thematic review) as necessary.

When inspecting specific financial firms, the SESC will identify priority issues for the inspection in advance and focus on them.

2) Implementation of effective inspection

A. Introduction of prior notice inspection

While maintaining the principle of not giving prior notice to the financial instruments firms to be subjected to on-site inspection, the SESC will introduce prior notice inspection on a case-by-case basis by taking account of the nature of the business of the targeted firm, the priority issues of inspection and the efficiency of inspection in a comprehensive manner.

B. Examination of the appropriateness of the internal control system

When any deficiencies in business operators' business operations have been identified, the SESC will examine their internal control systems and risk management systems (hereinafter referred to as the "internal control systems, etc.") regardless of whether there has been any violation of laws and regulations, so as to identify problems that may be inherent in the systems. In examining the appropriateness of the internal control systems, etc., the SESC will pay attention to whether the systems have been developed with institutional involvement, such as the involvement of the management team. The SESC will particularly focus on the appropriateness of the internal control systems, etc. for financial instruments firms whose position in the market and the nature of their business are important.

C. Enhancement of interactive dialogue

The SESC will strive to share the recognition of deficiencies in business operations with inspected financial instruments firms through dialogue with them. In particular, the SESC will check through a dialogue with the management team, which is responsible for the development of the internal control systems, etc., on their recognition on their deficiencies and will

encourage them to make voluntary improvement efforts if necessary.

3) Enhancement of cooperation with relevant regulatory agencies

- The SESC will cooperate with supervisory authorities to promote the sharing of information and concerns through an exchange of information useful for inspection obtained through off-site supervisory activity and vice versa. In particular, regarding the inspection and supervision of financial instruments firms, which occupy an important position in the market, the SESC will seek close cooperation with the supervisory authorities in on-site and off-site monitoring.
- Regarding cooperation with the Inspection Bureau of the FSA, the SESC will share regulatory concerns with them. In addition, the SESC will enhance coordination, in the light of the smooth implementation for inspections toward the business operators which belong to a single financial conglomerate, through the implementation of simultaneous inspection on business operators that constitute a financial conglomerate and through the exchange of opinions, if necessary.
- Regarding cooperation with Self-Regulatory Organizations (SROs), the SESC will strengthen coordination between its inspection and on-site/off-site reviews conducted by the SROs on their member firms so as to improve the monitoring function on the financial instruments firms as a whole. From this perspective, the SESC will promote the sharing of regulatory concerns with the SROs through the exchange of information and cooperation in the training of inspectors.
- Regarding cooperation with overseas securities regulators, the SESC will strengthen cooperation regarding the inspections for foreign financial instruments firms or Japanese financial instruments firms which have overseas offices or business-sites, with them, through an exchange of necessary information. In addition, the SESC will enhance cooperation with the relevant overseas regulators through more active involvement in the “Supervisory College,” which was set up for each of the major international financial institutions.
- In the inspections of the financial instruments business operators that manage and sell financial products of collective investment schemes (investment

funds) many cases of fraudulent practices being employed or unregistered firms being involved in, were found. In order to address these issues, the SESC will promote cooperation with the supervisory authorities and investigative authorities.

4) Formulation and revision of the inspection manuals

The SESC partially revised the “Inspection Manual of Financial Instruments Business Operators” in March this year in accordance with regulatory reforms, including the establishment of the loss-cut rule, the obligation for compliance therewith, and the unification of segregated management methods into money trusts with regard to foreign exchange margin trading (FX trading), as well as the introduction of the obligation to conduct segregated management of over-the-counter trading of securities derivatives. The SESC will inspect firms engaging in the FX trading business in light of the viewpoints based on the revision.

Furthermore, as the authority to inspect credit rating agencies was given in April this year, the SESC formulated and published the “Inspection Manual for Credit Rating Agencies” this March. The SESC will formulate and revise inspection manuals in accordance with future regulatory reforms so as to improve the transparency and predictability of its inspection.

(2) Areas of inspection focus

1) Exercise of the gatekeeper functions

A. On market intermediary functions of financial instruments firms

To develop and maintain fair, transparent and high-quality financial and capital markets, it is extremely important for financial instruments firms to fully exercise the function of preventing persons and entities that intend to abuse and misuse the market from participating in the market, through the management of customers, trade examination, underwriting examination (due-diligence) and other activities. The SESC will examine whether financial instruments firms are properly exercising this function.

As part of this examination, the SESC will check how inspected financial instruments business operators are developing their information gathering systems to prevent anti-social forces from making transactions. Regarding the reporting of suspicious transactions, the SESC will examine whether the

operators make efforts to establish the checking systems, including the development of internal rules. In addition, the SESC will examine whether the identity verification measure is properly implemented when a new account is opened or when the applicant for a new account is suspected of using a stolen identity.

Furthermore, to encourage the adequate functioning and sound development of capital markets, the SESC will examine whether underwriting operations, including due diligence, information management, trade management and distribution, are appropriately executed from the viewpoint of protecting investors. As for financial instruments firms that arrange, underwrite and sell securitized instruments, such as CDOs and high-risk derivative products, the SESC's inspection will focus on their underwriting examination, risk management and sales management systems.

B. On the management of undisclosed corporate information

(Prevention of unfair insider trading)

In order to prevent unfair insider trading, the SESC will examine whether financial instruments firms are properly managing undisclosed corporate information. To be more specific, the SESC will examine whether the firms have developed an effective management system with regard to the registration of undisclosed corporate information, the restriction on stock trading by officers and employees, the firewall related to information access, and the trading examination.

C. On conduct that may hinder fair price formation

Fair price formation is the essential element of the fairness and transparency of the market and serves as the basis of investors' trust in the market. During its inspection, the SESC will not only check whether practices that may hinder fair price formation are being employed but will also examine the trade management systems of financial instruments firms to prevent such practices. At the same time, the SESC will examine management systems for short selling (including the management of delivery failures) on an as-needed basis.

In particular, regarding financial instruments firms operating online trading or providing electronic facilities for DMA (direct market access), the SESC will examine whether they have established effective trade management

systems that take account of the extraordinary nature of the electronic transactions: that customer orders are directly and instantly fed into the market.

2) Examination of the internal control systems, etc.

A. On the internal control systems, etc.

While making it a principle to conduct examination to detect illegal practices, the SESC will also focus on the examination of the appropriateness of the internal control system and the risk management system, including the soundness of the financial position, in light of the size and nature of the inspected financial instruments firms. In particular, regarding financial instruments firms that have an important position in the market, the SESC will examine the appropriateness of the internal control systems, etc. from the forward-looking perspective so as to prevent the exposure of risks related to their business operations and financial position.

B. On the appropriateness of the management of IT system risk

In recent years, financial instruments firms have become increasingly dependent on IT systems in their management of business operations, while many individual investors have come to participate in Internet-based securities transactions and FX trading. Thus, IT systems have become an important infrastructure of financial transactions.

Under these circumstances, it is very important to secure the stability of IT systems from the viewpoint of protecting investors and ensuring public trust in the market and in financial instruments firms. In its inspection, the SESC will examine the appropriateness and effectiveness of the IT operational risk management system, including the handling of IT system problems and the management of outsourcing service providers, and check whether the management team is involved in the development of the IT operation risk management system, in order to prevent exposure to risks.

3) Examination from the viewpoint of the protection of investors

A. On the status of solicitation for investment

To protect investors and secure fair sales attitudes, the SESC will examine whether financial instruments firms are soliciting customers for investment

in an appropriate manner and are taking appropriate care in dealing with them. Regarding the status of solicitation for investment, the SESC will conduct examination from the viewpoint of the suitability rule in particular, by checking whether financial instruments firms are appropriately soliciting for investment in light of customers' knowledge, experience and asset status as well as their purpose of investment, and whether they are fulfilling their duty of accountability to customers in a manner suited to the customers' attributes. As for products whose structures are complex, such as derivatives, the SESC will examine whether necessary and adequate explanations regarding important risks that may affect investment decisions concerning such products are provided to customers. In addition, the SESC will examine whether advertisements which are widely exposed to investors, do not include misleading indications regarding investment effects, market factors and the status of order execution. The SESC will also examine the status of the development of systems to process complaints, which is important for investor protection.

B. On the appropriateness of asset management business

While asset management firms are commissioned by investors to manage assets for the interests thereof, it is very difficult for investors to directly check the asset management status of the firms. Therefore, the SESC will examine asset management firms' compliance with the relevant laws and regulations, including the fiduciary duty and duty of care, as well as the effectiveness of their systems for managing conflict of interest and the due diligence function.

C. On the compliance with laws and regulations in relation to the management and sales of collective investment schemes (investment funds)

In light of the fact that the inspection of financial instruments firms which engage in the management and sales of collective investment schemes (investment fund) (hereinafter referred to as "investment fund firms") has uncovered many cases of serious violations of laws and regulations, such as the misappropriation of investment funds, the use of false and misleading indications, and the failure to implement segregated management, as well as inappropriate business practices that undermine the protection of investors,

the SESC will continue to examine the appropriateness of investment fund firms' management of business operations and whether there is any violation of laws and regulations. Moreover, as a result of inspection of investment fund firms, if an unregistered firm is found to be engaging in a business that requires registration, the SESC will take appropriate actions in cooperation with supervisory authorities and investigative authorities.

D. On compliance with laws and regulations by investment advisory firms and agencies

Regarding investment advisory firms and agencies, the SESC will continue to focus on the examination of their compliance with laws and regulations in light of the fact that many of those firms inspected were found to have violated laws and regulations due to a lack of awareness about legal compliance among officers and employees and an inadequate internal control system, for example by trading securities without registration, using markedly untruthful advertisements and making false statements in business reports. From the viewpoint of preventing serious violations of laws and regulations, the SESC will also examine systems for screening advertisements and processing complaints so as to ensure conscientious and fair handling of complaints.

4) Others

A. On appropriateness of the function of SROs

As for SROs, the SESC will examine whether self-regulatory operations are adequately effective, whether their functions are appropriately exercised, and whether they have systems necessary for exercising their functions properly. Specifically, the SESC will conduct verification with regard to the establishment of their self-regulatory rules for their members and their regulatory enforcement, such as on-site and off-site reviews, penalties, and listing examination and management. In the verification of listing examination and management, the SESC will focus on SROs' measures to prevent anti-social forces from intervening in the markets, including the collection of information on the involvement of anti-social forces in the issuing and listed companies.

Furthermore, in light of the significance of financial instruments exchanges as part of the market infrastructure, the SESC will focus on the examination

of the status of the development of systems for ensuring smooth and appropriate management of the financial instruments markets, such as IT operational risk management system.

B. On firms that have been newly included in the scope of firms subject to inspection and new financial instruments

Regarding credit rating agencies, which are to be subject to inspection starting in April this year, the SESC will examine the appropriateness of their business management systems by using the Inspection Manual for Credit Rating Agencies.

Regarding financial instruments firms that handle new types of financial instruments, the SESC will strive to grasp the actual state of their business operations and examine the status of the development of a management system related to the treatment of such products.

II. Basic Inspection Program

1. Basic Concept

(1) The SESC will formulate an inspection program based on the following concepts in principle while taking account of the nature, etc, of financial instruments firms' businesses. It should be noted that extraordinary actions may be taken in response to a change in the market environment or factors related to a specific firm, for example.

1) Regarding firms which underwrite, trade and solicit for financial instruments with a high level of liquidity, such as listed securities, and firms that manage assets on commission from investors for the interests thereof, the SESC will in principle examine the status of their management of business operations and the soundness of their financial position on an ongoing basis in light of the importance of their role in the market.

2) Regarding firms other than those specified in 1) above (e.g., firms which deal with financial instruments with a low level of liquidity or which only conduct investment advisory business), the SESC will judge inspection priority based on the analysis of information collected from supervisory authorities and other

sources in light of the extremely large number of firms subject to inspection.

- (2) The SESC will work with inspectors of the Local Finance Bureaus to conduct efficient and effective inspection through active use of joint inspection and the exchange of inspectors. The SESC will also provide support for the inspectors of the Local Finance Bureaus through sharing inspection techniques and information, and will cooperate with them in the handling of the inspection results, and will integrally conduct inspection activity.

2. Basic Inspection Program

Type I Financial Instruments Businesses firms (including Registered Financial Institutions) and Asset Management firms	150 firms (including 110 firms to be inspected by the Local Finance Bureaus)
Investment advisory firms/agencies, Type II Financial Instruments Businesses operators and financial instruments intermediaries, etc.	To be inspected on an on-going basis
Self-regulatory organizations	To be inspected as necessary

(Note) The figures are subject to change due to the revision of the inspection program during this business year and/or the implementation of special inspections.