

## **The Securities Inspection Policy and the Program for FY2015**

### **I. Securities Inspection Policy**

#### **1. Basic Direction**

##### **(1) Role of securities inspections**

The mission of the Securities and Exchange Surveillance Commission (SESC) is to ensure the fairness and transparency of the Japanese capital and financial markets and to protect investors.

The objective of securities inspections for the achievement of this mission is to ensure investor confidence in the markets, by conducting on-site examinations of financial instruments business operators (FIBOs) with regard to the business operations and their financial soundness, and by urging them to operate businesses in accordance with laws, regulations, and market rules on the basis of self-discipline, and play the market intermediary functions, including duties as gatekeepers, in a proper manner.

Therefore, through securities inspections, the SESC should examine FIBOs' compliance with laws and regulations, and verify the internal control systems behind individual problems.

The SESC will continue to take rigorous actions against illegal activities that undermine confidence in the fairness and transparency of the markets or impair investors' rights by exercising its own authority and mobilizing all its human resources and capabilities, and will thus play a role in sending alerts to the markets.

##### **(2) Environment and issues facing securities inspection**

Business operators (BOs) subject to inspection have diversified and increased to around some 8,000 in total. In addition, the widespread international activities of market participants have led to more diverse and complex financial instruments and transactions conducted by FIBOs.

Under these circumstances, the SESC's inspections should mainly focus on the following issues.

- (i) Constantly monitor large-scale securities company groups' financial soundness as a

whole, given that they are required to upgrade their governance and risk management to be level with their business models while keeping up to date on economic and financial conditions and the progress in international discussions regarding financial regulations;

- (ii) In view of the recent fraud cases involving AIJ and MRI and insider trading cases concerning public stock offerings, implement securities inspections rapidly and properly to prevent serious wrongdoings that may damage investors' confidence in the market intermediary function of FIBOs; For securities inspections, not only verify compliance with individual laws and regulations, but also continuously urge FIBOs to improve their compliance posture and professional ethics in the course of business management and internal control activities;
- (iii) Given that the reliability of IT systems is becoming increasingly important on the back of increased internet trading, high-frequency trading (HFT), direct market access (DMA), etc., concentrate on verifying the appropriateness of IT system risk management in order to avoid adversely affecting capital/financial markets and trades executed by customers; and
- (iv) In view of the situation where losses to retail investors and consumers from sales and solicitation of funds are growing and resulting in social problems in recent years, from the viewpoint of protecting investors, continue to take rigorous actions against unregistered BOs and persons making notifications for business specially permitted for qualified institutional investors ("QII business operators"), which violates the Financial Instruments and Exchange Act ("FIEA"), In close cooperation with relevant authorities, make full use of the faculty to file petitions for court injunctions regarding activities prohibited under the FIEA, conduct investigations, and disclose the results of investigations where necessary.

### **(3) Toward efficient, effective, and viable securities inspections**

Under the above circumstances, the SESC, while working to obtain an accurate understanding of existing overall business conditions through close cooperation with related supervisory departments will utilize its limited human resources appropriately and effectively by determining the inspection priority and frequency in order to achieve efficient, effective, and viable inspections.

Toward this direction, the SESC will further enhance its ability to identify potential problems with consideration of (i) the characteristics of diverse business types of FIBOs, (ii) the characteristics of customers, and (iii) the characteristics of increasingly complex and diverse financial instruments and transactions. Also, the SESC will strengthen its capabilities to collect and analyze information accordingly.

Furthermore, when determining inspection priorities for individual BOs, the SESC will collect and analyze a variety of information concerning them, corresponding to their business types, sizes, other characteristics, and the market conditions at the time, and then utilize a risk-based approach to decide which BOs to inspect, considering their market positions and inherent problems in a comprehensive manner. In addition, with regard to the execution of inspections, the SESC also clarifies the scope of inspections and inspection measures according to its inspectorial targets and its issues.

Additionally, when it is necessary to examine issues encompassing multiple markets and common issues, the SESC, where necessary, will conduct inspections targeting multiple BOs for specific inspection items.

Further, for governance and internal control issues, the SESC will hold interactive discussions considering business condition, scale, characteristics, etc. of the BOs under inspection, and, as necessary, urge them to improve their business operations.

#### **(4) Securities inspection keeping the Financial Monitoring Policy in mind**

The SESC will work in cooperation with the Financial Services Agency (“FSA”) and implement combined on- and off-site monitoring. To this end, the SESC will conduct inspections keeping in mind the key priority measures and focuses of supervisions/inspections that are stipulated in the Financial Monitoring Policy for 2014-2015 (September 2014) from the viewpoint of building a positive cycle that will contribute to medium- to long-term market growth and help FIBOs generate a steady stream of profits, including:

- Effectively responding to the needs of customers (upgrading asset management capacity)
- Fulfilling the functions toward providing funds for growth
- Ensuring customer trust/security
- Forward-looking risk management of large-scale securities company groups, etc. and supervision from a global viewpoint
- Managing business risks in small and medium-sized securities companies, investment companies, etc.

For example, from the viewpoint of effective response to the needs of customers (upgrading asset management capacity), the SESC will endeavor to understand the existing business conditions and establish a common view with BOs under inspection through interactive communications for better business management, in cooperation with the relevant supervisory departments, regarding issues such as whether fiduciary duties<sup>(\*1)</sup> are incorporated in investment managers’ product development and operation to provide products that truly

satisfy customer needs and interests, whether their investment activities are sufficiently independent of group sales companies; and whether securities companies offer products/services that truly meet customer needs and interests, regardless of the level of commission/fees and the corporate group association.

(\*1) A general term for the extensive and various roles and duties of a trustee who must fulfill certain obligations entrusted by the counterparty (entrustor)

(\*2) The Securities Inspection Policy and the Program for FY2015 is subject to change in alignment with the FSA's financial monitoring policy.

## **2. Inspection Items in Securities Inspection**

### **(1) Focuses of verification corresponding to the types of businesses**

#### **1) Large-scale securities company groups.**

In view of the Financial Monitoring Policy, the SESC, from a forward-looking perspective, will verify the appropriateness of internal control, governance, and risk management in large-scale securities company groups. Specifically, in addition to the focus of verification regarding Type I FIBOs stipulated in item 2) below, this would include verification of the appropriateness of group-wide, comprehensive risk management, such as whether governance and risk management frameworks in large-scale securities company groups can respond forcefully to changes in the global market environment, and whether they appropriately manage profitability and potential impacts on equity capital, including from the aspect of financial resilience against changes in market conditions. Further, in view of the increase in overseas and cross-border business and the fact that there are a number of cases where financial institutions have been imposed with large penalty payments by foreign supervisory authorities, the SESC will verify whether large-scale securities company groups are taking appropriate action to improve their operational risk and compliance risk management.

In conducting inspections, the SESC will endeavor to cooperate with relevant supervisory departments smoothly through combined on- and off-site monitoring, etc., and will identify/clarify issues and risks by conducting off-site interviews throughout the year, thereby getting a grasp of the existing conditions of business operations in large-scale securities company groups. The SESC will also conduct targeted on-site inspections with specific inspection themes to improve effectiveness and efficiency.

#### **2) Type I FIBOs**

##### **A. Verification of the management of material non-public information (prevention of**

**unfair insider trading)**

The SESC will continue to focus on verifying whether FIBOs strictly manage material non-public information from the perspective of preventing unfair insider trading. Specifically, the SESC will verify whether FIBOs have developed viable management systems with regard to registration and information barriers (e.g. Chinese wall) of such material non-public information as public stock offerings of listed companies, surveillance of insider transactions, and prevention of any improper distribution and misuse of information.

**B. Verification of measures against conduct that may hinder fair pricing**

The SESC will continue to focus on verifying whether there are any practices that could hinder fair pricing by means of direct and/or brokered orders, and further examine the transaction surveillance systems of FIBOs to prevent such practices. In doing so, the SESC will verify whether viable transaction surveillance is conducted from the viewpoint of preventing unfair trading. In particular, the SESC will examine whether surveillance is focused on specific dates, such as the pricing dates for public stock offerings, and on specific trading timing, such as just before closing, or on specific customers who repeatedly place large orders that could affect pricing in the market, as well as whether measures are taken to identify the original customers for orders consigned from foreign-related entities. The SESC will also examine management systems, including the management of delivery failures, for short selling regulations (such as checking the indications of short selling, price regulations, the prohibition of naked short selling, etc.).

**C. Verification of the progress on establishing viable trade surveillance systems for DMA, etc.**

As far as FIBOs with online trading or electronic facilities for DMA (direct market access) are concerned, in view of the cases of revelations of market manipulation by means of *misegyoku* (false orders to manipulate prices) using Internet transactions, the SESC will continue to focus on examining whether FIBOs have established viable trade surveillance systems based on the peculiarities of electronic transactions, such as customer orders feeding directly into the market.

**D. Verification of the appropriateness of securities underwriting**

Type I FIBOs play an important role in intermediary functions through the securities underwriting business by which enterprises can raise funds for business operations from investors in the market. The SESC will examine whether Type I FIBOs properly engage in securities underwriting business, including underwriting examinations, information control, transaction surveillance and securities allotment from the perspective of the capital

markets' integrity and investor protection. In particular, in connection with new listings, the SESC will verify whether examination systems appropriately function in underwriting public offering. In addition, as for FIBOs that arrange and distribute securitized instruments and high-risk derivatives products, their risk management systems and sales management systems will be examined.

**E. Verification of financial soundness**

Previous inspections of Type I FIBOs have revealed violations arising from deterioration of financial conditions, such as the misappropriation of the Trusts for the Separate Management of Money and Securities (TSMMS) and the Trusts for the Segregated Management of Cash Margins and Other Deposits (TSMCM), and defects in net assets and capital adequacy ratios against statutory requirement. The SESC will continue to focus its examination on the status of TSMMS and TSMCM, and the status of net assets and capital adequacy ratios in close cooperation with the supervisory department, the Japan Securities Dealers Association, and the Japan Investor Protection Fund.

**F. Verification regarding money laundering and terrorism financing**

In view of the implementation of the revised Act on Prevention of Transfer of Criminal Proceeds, taking into consideration the importance of personal identification at the time of transaction and appropriate reporting of suspicious transactions in terms of international cooperation in anti-money laundering and combating against terrorist financing, the SESC will continue to conduct inspections focusing on whether FIBOs examine their customers' objectives of transactions and their occupations at the time of new account opening, whether they properly conduct re-identification of customers when identity theft is suspected, whether they properly report suspicious transactions, and whether they have established systems for conducting these activities properly.

**G. Verification of FX business operators**

Among Type I FIBOs, the SESC will review FX business operators, focusing on whether they are taking appropriate measures against trades that use software that allow automatic trading (system trading) and against the slippage associated with their FX transactions in accordance with the guidelines for supervision and other relevant self-regulatory rules. Further, in view of potential sudden changes in the economic and financial environment, the SESC will also focus on FX business operators' foreign exchange risk management.

**3) Type II FIBOs (fund business operators)**

For inspections of Type II FIBOs, investment management business operators (IMBOs),

and QII business operators engaging in the fund management and sales of interests of collective investment schemes (funds) (collectively referred to as “fund business operators” or “FBOs”), these inspections will continue to focus on legal and regulatory compliance issues that include the appropriateness of business operations, such as segregation management of funds (whether there is any misappropriation of funds and unexplained expenditure), false explanations and notices, misleading indications, and name-lending to unregistered BOs.

In cases of overseas funds, it is difficult to check the detailed contents or characteristics of products directly, and if Japanese laws and regulations cannot apply to such products directly, it is difficult to protect the rights and interests of investors. In view of this, the SESC will examine whether BOs selling such products conduct sufficient and appropriate due diligence and monitoring activities for related funds and their issuers, managers, etc. in consideration of the risks involved in such products, and whether there are any problems of customer solicitation activities, in light of the principle of suitability and other investor protection.

#### **4) IMBOs**

Since many IMBOs incorporate external funds, including overseas funds, in their management portfolios, it is increasingly important for them to conduct due diligence and monitoring activities in a proper manner.

Under such circumstances, previous inspections, especially of business operators conducting discretionary investment management business (“DIM business operators”), have identified legal and regulatory violations including misleading explanations about important matters when soliciting customers, etc., provision of special profits to customers, and breaches of duties of loyalty in relation to providing discretionary investment management services. As such, the SESC will collect and analyze information appropriately and prioritize inspection targets, and inspect focusing on the viability of due diligence and monitoring activities, the appropriateness of investment solicitation, and the status of compliance with laws and regulations such as the duty of loyalty and the duty of care, as well as inspections of their systems for managing conflicts of interest in relation to transactions with stakeholders.

#### **5) Credit rating agencies**

The SESC will utilize information obtained through cooperation with supervising authorities in various countries and confirm whether credit rating agencies (CRAs) have

established business management systems from a viewpoint of preventing conflicts of interest, assuring fairness of rating processes, and preventing administrative errors, and whether they have appropriately disclosed information in relation to credit ratings assigned by them and their rating policies.

**6) Investment advisors/agencies**

Previous inspections revealed that some investment advisors/agencies committed legal violations of selling and soliciting financial instruments to customers without necessary registration as Type I or Type II operators. Some of them stated that they did not receive sales commissions, etc. from overseas funds, but in fact they did receive commissions from issuers of overseas funds, according to the amount of purchase by customers, by way of their overseas subsidiaries. In view of these cases, the SESC's inspection will continue to focus on whether there are similar cases to the above, as well as their status of compliance with laws and regulations and their systems for soliciting and providing explanations to customers.

**7) Self-regulatory organizations**

As for self-regulatory organizations (SROs), the SESC will conduct verifications with regard to the establishment of self-regulatory rules for their members and their regulatory enforcement, such as through on-site and off-site reviews and penalties, listing examinations, and transaction surveillance. In conducting verifications of listing examinations, the SESC will also look into the SROs' ongoing measures to thwart the intrusion of anti-social forces in the financial and capital markets, including the collection of information on the involvement of anti-social forces in issuing companies and listed companies.

As for financial instruments exchanges, clearing houses, depository trust institutions, etc., in consideration of the "Principles for Financial Market Infrastructures" finalized by the IOSCO, the SESC will examine the development of their systems, such as IT system risk management, in order to verify whether they are well-prepared to function as financial market infrastructure.

**8) QII business operators**

In addition to the misappropriation of funds and false explanations/notices as described in item 3) above, the SESC will confirm whether QII business operators engage in the unregistered selling/managing of funds that do not qualify for specially permitted businesses by notification, whether they appropriately collect/manage necessary



information about funds provided by customers and the performance of investments managed by the appointed investment managers, whether they appropriately provide information on investment performance, etc. to customers, and whether they conduct business by making false notifications to relevant supervisory authorities and engage in other problematic business. If the inspection reveals any violation of the FIEA or other problems in relation to investor protection, the SESC will continue to take rigorous action, including, for example, publicizing the names of the business operators subjected to inspection/investigation, the names of their representatives, and the committed violation of laws and regulations. Additionally, the SESC will utilize its authority to conduct investigations to file petitions for court injunctions, and file petitions where necessary.

**9) Dealing with unregistered BOs**

To deal with serious FIEA violations, such as sales, etc. of funds, etc. by unregistered BOs, the SESC will strengthen ties with supervisory departments and investigative authorities, and, where necessary, will make proper use of its authority to conduct investigations necessary to file petitions for court injunctions. If such conduct is confirmed as violating the FIEA or impairing investor protection, the SESC will continue to take rigorous action by filing petitions for injunctions, etc. and by publicizing the names of unregistered BOs, the names of their representatives, the facts of their violation of laws and regulations, and other relevant information.

**(2) Cross-sectional focuses of verifications**

**1) Focus of verification on sales/solicitations of financial instruments**

In order to protect investors and ensure that sales and solicitations by FIBOs are trustworthy and fair, the SESC will continue to focus on verifying whether FIBOs solicit customers for investment in an appropriate manner and handle customers properly.

Regarding verifications of sales and solicitations for financial instruments, the SESC will verify, from the viewpoint of the principle of suitability, whether FIBOs are appropriately soliciting investment in light of customers' knowledge, experience, and assets, as well as the investment purpose, and whether they are fully held accountable for their solicitation in accordance with the characteristics of individual customers.

In particular, the SESC will also examine whether appropriate explanations are provided regarding important information that affects customers' investment decision-making in relation to sales and cancellations, including the switching of investment trusts, such as product characteristics, risk characteristics, profits/losses, dividends, commissions, and

investment trust fees.

For the sale of over-the-counter (OTC) derivatives products and complex structured bonds similar to OTC derivatives products, the SESC will examine whether appropriate explanations are provided regarding important risks and other factors that affect decisions for investment in such products, including the probable maximum losses and the settlement money on cancellation.

In addition, the SESC will verify whether FIBOs have established systems for soliciting and providing explanations to aged customers or those customers who have limited knowledge and experience related to investments who utilize Nippon Individual Savings Accounts (NISA).

Moreover, the SESC will verify whether widely exposed advertisements to investors and other solicitation materials include any misstatements or misleading indications regarding investment returns, market factors, and the state of orders. The SESC will also examine the establishment of a troubleshooting system important for investor protection.

## **2) Verification of IT system risk management**

In recent years, IT systems have become essential infrastructure for financial transactions, and it is very important to secure the stability of IT systems and establish crisis management measures from the viewpoint of protecting investors and ensuring public confidence in the market and FIBOs. The SESC will continue to examine the appropriateness and viability of management systems for the IT systems risk preventive measures, as well as the efficacy of business continuity plans, including erroneous order placement prevention, IT systems troubleshooting, information security management, cybersecurity measures, and outsourcing management. At the same time, the SESC will also verify whether the top management fully understands the importance of the IT systems risk preventive measures and whether they proactively engage in the investment and management of the IT systems and the risk management activities.

## **3) Verification of measures to eliminate relations with anti-social groups**

The SESC will continue to examine whether FIBOs have established an internal system to prevent new transactions with anti-social groups, to conduct *ex post* reviews of the existing transactions with them, and to address dissolving such transactions, if any, under the proactive involvement of top management, in order to eliminate connections with anti-social groups in organization-wide efforts,

**(3) General verification items**

In addition to those described above, the SESC will review issues associated with governance, legal/regulatory compliance, internal control, risk management, audits, and crisis management (collectively referred to as “Internal Control Systems, etc.”) through the use of “Inspection Manual for FIBOs,” etc.

Upon identification of any issue related to business, the SESC will check the appropriateness and viability of the Internal Control System, etc. that seems to be causing problems in order to gain a thorough understanding of the issue. In examining the Internal Control Systems, etc., the SESC will pay attention to the engagement and commitment of the senior management and concerned parties in the system management.

## **II. Securities Inspection Program**

- (1) For FY2015, the SESC intends to conduct inspections of 270 business operators (of which 220 will be inspected by relevant Local Finance Bureaus).
- (2) Type I FIBOs, Type II FIBOs, IMBOs, and CRAs remain subject to routine inspection.  
For investment advisories/agencies, financial intermediaries, etc., in view of their types of businesses, scales, and other characteristics and the limited availability of human resources at the SESC/Local Finance Bureaus in light of the substantial number of business operators subject to inspection, the SESC will continue to prioritize inspection targets using the information provided by the relevant supervisory departments and externally available information, and conduct inspections on an as-needed basis considering these business operators' statuses of legal/regulatory compliance and participation in self-regulated organizations.  
Self-regulatory organizations will be inspected when it is considered necessary.
- (3) For Type II FIBOs and investment advisors/agencies, the SESC will continue to verify as soon as possible following their registration, whether they have established the same business management systems as reported in their applications for registration ("post-registration review").
- (4) For registered financial institutions, inspections in FY2015 will be conducted if it is deemed necessary to conduct on-site inspection based on the information provided by the FSA's Inspection Bureau and Supervisory Bureau, external information, and the results of off-site monitoring, etc.
- (5) For QII business operators, the SESC will continue to inspect them appropriately, utilizing information actively provided by the Supervisory Bureau, external information, etc. Additionally, given the extremely large number of operators subjected to inspection, the SESC will endeavor further to improve inspection methods to increase the number of business operators covered by inspection.
- (6) The SESC plans to develop inspection methods for crowdfunding business operators, in cooperation with SROs, in accordance with the legal framework for such business developed in the revised FIEA in FY2014
- (7) In conducting inspections, the SESC and Local Finance Bureaus will continue to endeavor to conduct efficient and effective inspections together by exchanging inspectors, etc.

Joint on-site inspections by the SESC and Local Finance Bureaus, which mainly target head offices and branches of Type I FIBOs, will be conducted when necessary based on the results of off-site monitoring, in view of the administrative burden on inspected business operators, in FY2015.

- (8) The SESC will continue to conduct investigation against unregistered business operators in a timely manner, utilizing external information.
- (9) The SESC, in an effort to fulfill its missions adequately, will take rigorous actions against any conduct that would hinder the viability of inspections, such as attempts to avoid inspection.

Note: Depending on the nature of environmental changes and each BO's circumstances, there may be situations where we need to take actions flexibly without relying on this Securities Inspection Program.