October 25, 2016

Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2016 - June 2017)

Introduction

In 2015, the Financial Services Agency (JFSA or Agency) began issuing a document entitled *Strategic Direction and Priorities* (SDP), which sets forth the JFSA's objectives for the business year (July through June of each year) and its planned implementation approach to achieve those objectives. The SDP for the current business year (July 2016 – June 2017) indicates the Agency's intention to improve the effectiveness and efficiency of its monitoring of financial instruments business operators, and so on. (FIBOs, or securities businesses[1]) by promoting closer cooperation between relevant departments in the JFSA and taking a more seamless approach to on-site and off-site monitoring.

Based on the objectives set forth in the SDP for the current year, the Securities and Exchange Surveillance Commission (SESC) has decided to collaborate more closely with relevant departments of the JFSA in its monitoring activities and to conduct integrated on-site and off-site monitoring of all FIBOs. In addition, it has determined to begin releasing an annual statement entitled *Monitoring Priorities for Securities Businesses* setting forth its general approach to monitoring FIBOs, including its areas of focus in such monitoring, in the coming year. This document replaces the annual *Securities Inspection Policy* documents issued in previous years.

1. Monitoring Priorities for Securities Businesses

(1) Monitoring securities businesses in a changing market

In view of the SESC's mission to ensure fairness and transparency of the markets and the protection of investors, effective monitoring of securities businesses is essential to promote investors' confidence in the market. An effective monitoring program will encourage FIBOs to have appropriate controls in place to help to ensure that they operate in compliance with relevant laws,

[1] FIBOs or securities businesses are any businesses that are subject to securities monitoring pursuant to the Financial Instruments and Exchange Act (FIEA), including financial instruments business operators, registered financial institutions, financial instruments intermediary service providers, qualified institutional investor business operators, credit rating agencies, and so on.

regulations, and market rules. Such controls will enhance the ability of firms to perform their function as market intermediaries and gatekeepers.

This monitoring program has taken into account recent developments in the financial markets. FIBOs are facing increasingly complex domestic and global developments that present significant and diverse challenges to their operational and compliance strategies. Specifically, on the domestic front, they face a changing customer base due to the aging population, and a changing investment environment with the introduction of negative interest rates, even as the financial markets have continued to recover from the global financial crisis in 2008. Globally, FIBOs face challenges from the slowdown in growth in Chinese and other emerging economies as well as Brexit. In addition, as with financial firms around the world, the growing threat from cyberattacks, combined with the growth of FinTech, has made it imperative for FIBOs to improve the security and stability of their IT systems.

Meanwhile, the number of securities businesses subject to monitoring by the SESC has increased to approximately 8,000 in total, and these firms offer an increasingly diverse and complex set of services, products, and trading strategies. The SESC's monitoring policy must take into account these industry trends, along with the broader financial market developments described above. In addition, the SESC's monitoring policy will need to take a more proactive approach to monitoring securities businesses regarding requirements of investor protection, including those enacted in amendments to the Financial Instruments and Exchange Act related to the Specially Permitted Businesses for Qualified Institutional Investors that took effect in March 2016.

(2) Principle approach to monitoring securities businesses

In its monitoring of securities businesses, the SESC has historically focused on reviewing an entity's control environment for legal/regulatory compliance, risk management, and financial soundness, as well as its internal control environment, and it has typically conducted these reviews through on-site monitoring.

In the current business year, the SESC intends to introduce a new monitoring framework that integrates on-site and off-site monitoring of all securities businesses into a seamless process. This process will be based on an off-site risk assessment of the entity's business model, and both the effectiveness of its governance and the appropriateness of its risk management in light of its business model. This approach will evaluate the effectiveness of the entity's three lines of defense: as the first line of defense, its front-office functions, which are responsible for recognizing and managing risk directly related to their day-to-day operations; as the second line of defense, its risk-management and compliance functions, which oversee the risk management implemented by the front-office functions and verify its effectiveness; and as the third line of defense, its internal audit functions, which are responsible for verifying the controls implemented by front-office, risk-management and compliance functions. The assessment will take into consideration the individual characteristics of each FIBOs, including its business model and the scale of its operations.

The SESC will use the results of this off-site monitoring, together with risk-based analysis, to determine which securities businesses will be subject to on-site monitoring. In carrying out on-site monitoring of a securities business, the SESC will conduct in-depth analyses of the entity's products and transaction strategies to assess its compliance with relevant laws, regulations, and market rules. When these analyses identify a problem, the SESC will go further to identify the root causes of the problem.

2. Monitoring strategies for various FIBOs business models

The SESC's monitoring program will implement the specific key approaches set forth in the SDP, while focusing on review of issues that are particularly relevant to different FIBOs business models as described below.

(1) Large securities business groups (*i.e.*, Japanese securities companies with global operations)

Monitoring of large securities business groups will take a forward-looking perspective, focusing on assessing any changes to, and the sustainability of, the firm's business model; the functioning of its governance functions, risk management, and internal controls; and potential operational risks and other issues affecting the entire group.

Particular areas of focus will include the following:

- whether the front-office functions understand the firm's management strategies and recognize and manage risks accordingly;
- whether the risk-management and compliance functions are performing their role in monitoring front-office functions and verifying that they are appropriately managing risks; and
- whether the internal audit is functioning effectively.

The SESC will also urge securities businesses, where necessary, to take proactive actions against identified issues.

The SESC will also look at the global business activities of these groups, including their overseas operations, and, by taking their business strategy into consideration, review the sustainability of their business models and the appropriateness of their risk management programs.

Other specific issues for monitoring are:

- appropriate controls regarding the handling of material non-public information to prevent market misconduct;
- an effective trade surveillance system for direct market access (DMA) trading and high frequency algorithmic trading; and
- appropriate due diligence processes in their securities underwriting business that ensure their effective role as intermediaries to facilitate corporate financing.

(2) Securities companies, other than those described above

Monitoring of these securities companies will focus on changes in their customer base and profit structures, particularly those arising from the aging demographic profile of their customers, and assessing the appropriateness of their business operations in light of their scale and business models. With respect to this, the SESC will review each firm’s governance in light of the size of its operations and business model, including whether it has an effective internal audit program that is carried out by an independent division.

With respect to foreign securities firms, in addition to the issues described above, the SESC will also review the Japanese business operations of such firms in light of each firm’s business model and the firm’s global profit trends. The SESC will also focus on whether such firms have an effective trade surveillance system for DMA trading and high frequency algorithmic trading.

Finally, in the 2015 – 2016 business year, the SESC identified several cases in which local securities companies provided false information to customers in connection with solicitations for investments in bonds. The SESC will monitor whether these firms are sufficiently assessing the risks of the products.

(3) Foreign currency margin transactions (FX transactions) business operators

The SESC will review whether FX transactions business operators have measures in place to protect investors, such as advance disclosures to customers regarding the risks of such transactions, including possible sudden declines in liquidity leading to the expansion of spreads or potential slippages. In addition, the SESC will monitor whether these business operators have viable measures in place to manage the market risks of foreign exchange transactions.

(4) Investment management business operators (IMBOs)

The SESC will increase its focus on governance at IMBOs (for example, whether they maintain management and operational independence from sales affiliates, including with respect to managing conflicts of interests and exercising voting rights) and at the funds under their management (for example, a management/control system focused on investors' needs), as well as the status of their internal controls and audits. The SESC intends to develop benchmarks for effective monitoring of these business operators.

(5) Investment advisors/agencies

The SESC intends to review whether investment advisors/agencies are placing advertisements that are misleading to customers or are otherwise soliciting them by deceptive means.

In view of the recently expanding use of robo-advisers in investment advice and asset management services, the SESC will also increase its understanding of how such technologies are being used in the market.

(6) Type II FIBOs

The SESC intends to review Type II FIBOs for the substance of invested businesses and whether money invested in funds is managed appropriately.

(7) Qualified institutional investor business operators (QII business operators)

The SESC will review the substance of invested businesses and whether money invested in funds is managed appropriately, and check whether qualified institutional investors have actually invested money in the funds.

In view of the 2015 amendment to the Financial Instruments and Exchange Act, which restricted the scope of investors, expanded business conduct protections, and provided the JFSA with an authority for administrative actions, the SESC has been focusing on reviewing the operations of QII business operators since March 1, 2016.

(8) Other securities businesses subject to monitoring pursuant to the FIEA

For other securities businesses, including registered financial institutions, credit rating agencies, financial instruments intermediary service providers, and self-regulatory organizations (SROs), the SESC focuses on relevant risks in light of the firm's particular business types.

(9) Unregistered business operators

In order to prevent damage to investors from unregistered business operators, the SESC will strengthen cooperation with the JFSA's Supervisory Bureau, Local Finance Bureaus, and other investigative authorities, and, where appropriate, exercise its investigative authority to seek injunction in the court to force such firms to cease or suspend activities that violate the FIEA. The SESC will also pursue other measures against such firms, including public disclosure of their names, the names of their representatives, and the nature of their illegal conduct.

3. Industry-wide and thematic monitoring priorities

The SESC intends to review the effectiveness of governance, IT systems, risk management, internal audit, and legal/regulatory compliance at securities businesses across all business sectors in light of each firm's scale and business model, and encourage them to address any identified issues.

The SESC will also monitor securities businesses across the industry with a particular focus on their progress in implementing the following:

- customer-first business practices ("Fiduciary Duty");
- cybersecurity;
- trade surveillance of DMA trading and high frequency algorithmic trading,

in cooperation with the FSA's monitoring functions.

The SESC will change the focus of its industry-wide and thematic monitoring in response to changes in the market environment.

4. On-site monitoring

The SESC will take a seamless approach to on-site monitoring, utilizing risk-based approaches to decide when to conduct on-site monitoring of particular securities businesses with due consideration of various factors, including the results of off-site monitoring. On-site monitoring will focus on items for which review has been deemed necessary.

In carrying out on-site monitoring, the SESC will conduct in-depth analyses of relevant products and transaction strategies, and then review the appropriateness of a FIBOs' business operations. If a problem is identified, the SESC intends to go beyond just identifying violations of laws and regulations and to conduct additional analysis to identify root-causes of any identified problems through review of the firm's management policies and strategy, its governance, and its personnel and remuneration policies. The root-causes analysis should help to encourage securities businesses to develop an effective response to prevent recurrence of similar problems in the future.

5. Cooperation with Local Finance Bureaus and other relevant organizations

The SESC and Local Finance Bureaus will enhance their cooperation in monitoring securities businesses. In order to ensure a uniform approach for monitoring, the SESC will support the individual bureaus in planning and implementing off-site monitoring.

In cases where off-site monitoring suggests the operational risk of a FIBO is significant or where a FIBO subject to review falls under the jurisdiction of multiple bureaus, the SESC will conduct on-site monitoring of a FIBO under the jurisdiction of one or more Local Finance Bureaus alone or jointly with them.

The SESC will continue to work closely with SROs, including by sharing perspectives on problems with them to raise the efficiency of the monitoring program and ensure fairness and transparency in the markets. The SESC will also consider the best balance between monitoring by the SESC and audit/examination by SROs and how best to facilitate cooperation between the SESC and the SROs.

6. Publication of significant cases

The SESC intends to provide the public with more information about its monitoring of securities business, with specific and straightforward information to help market participants to understand the scope of the review of a securities business and problems that were identified. In particular, the SESC intends to disclose more of the examples of specific cases. The SESC also provides feedback to individual FIBOs, where necessary, by working closely with the JFSA's Supervisory Bureau.