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Message from the Chairman

The Securities and Exchange Surveillance Commission (SESC) was established on July 20, 1992, as an independent agency. Our mission is to ensure fair transactions in the securities and financial futures markets, thereby maintaining the confidence of investors in these markets.

Leading up to the time of our establishment, there were growing calls for

- 1) a change from ex-ante adjustment policies to nondiscretionary, ex post facto surveillance-based policies based on more transparent rules
- 2) separating the surveillance and supervision of securities companies

To accomplish these goals, the SESC was established as an independent agency and given statutory power to carry out inspections of securities companies, daily market surveillance, and investigations of criminal offenses.

Recently, the environment surrounding both securities regulators and markets in Japan has changed considerably.

First, as a result of a change in the regulatory framework, a new integrated financial regulator called the Financial Services Agency (FSA) was established on July 1, 2000. The FSA became the parental body of the SESC, but the SESC maintained its independence in exercising its power. Since then, not only regulators but also self-regulatory organizations in Japan experienced significant changes. Two new markets were established for start-up companies to raise capital: Mothers, which was established by the Tokyo Stock Exchange, Inc., (TSE) in November 1999, and NASDAQ Japan, which was established by the Osaka Securities Exchange, Inc., (OSE) in May 2000. The two markets were opened amid intensifying market competition that was partly caused by the appearance of proprietary trading systems in Japan. As the TSE, the OSE and Nagoya Stock Exchange changed from a mutual organization to a stock corporation and the Hiroshima Stock Exchange, Niigata Stock Exchange, and Kyoto Stock Exchange closed down, new challenges arose.

Second, the securities market experienced the following changes as a result of a drastic reform of Japan's financial system:

- a shift from a licensing system to a registration system for securities companies in December 1998
- an end to the obligatory concentration of trading on the exchange in December 1998
- the liberalization of brokerage commissions in October 1999
- a lift of restrictions on the business of the securities subsidiaries of banks in October 1999.

In the midst of the above-mentioned changes, we are facing new forms of illegal activities. SESC inspections revealed illegal cases concerning new financial devices, such as exchangeable bonds, in the form of stock price manipulation to evade payment for bonus coupons and solicitations using false or misleading statements. Therefore, transactions subject to SESC inspection and investigation have become complicated and diverse. Therefore our role to ensure fair and transparent securities transactions is becoming more significant.

The SESC intends to exercise its authority to the maximum extent to ensure fair securities transactions and protect investors. I sincerely hope that this report would enhance public understanding of the SESC and its activities in the markets.

Takeo Takahashi
Chairman
Securities and Exchange Surveillance Commission

Summary

The following is a summary of the Securities and Exchange Surveillance Commission's (SESC's) main activities in SESC year 2001 (July 1, 2001, to June 30, 2002)

1. Investigations of criminal offenses

To ensure fairness in markets, it is important to build investors' confidence in the authorities' ability to closely watch those markets. Such confidence can be built by a strict enforcement of related laws and regulations. From this perspective, the investigation of criminal offenses is regarded as one of the most essential duties of the SESC.

During the year under review, compulsory investigations (which included searching the suspect's premises and seizing related evidence) were conducted into transactions involving Shimura Kako Co. stock (suspected of market manipulation).

The SESC filed a total of seven complaints with public prosecutors against violations of the Securities and Exchange Law (SEL): three cases of insider trading, one case of market manipulation, and three cases of window dressing.

In the ten years since its establishment, the SESC has filed a total of 43 complaints: 16 cases of insider trading; seven cases of a loss of compensation; three cases of spreading rumors; five cases of market manipulation; nine cases of submitting securities reports containing false information, etc.; two cases of selling securities using deception; and one case of failing to submit reports on large shareholders.

2. Inspection of securities companies

Compliance with the law by securities companies is the first step required in ensuring fair securities transactions in the markets as a whole. The SESC inspects securities companies for compliance with transaction rules. During the year under review, inspections commenced on 96 domestic and foreign securities companies, seven registered financial institutions, and two self-regulatory organizations (SROs). Problems were discovered, and reported, in 57 out of 90 companies in which inspections were completed.

SESC inspections uncovered numerous violations of laws, among other things, conclusions

of discretionary account contracts, transactions to create an artificial market and the acceptance of orders for such transactions, and undue short selling. SESC inspections also uncovered many problems concerning sales practices and the internal control systems of securities companies. These were deemed to be caused by a lack of awareness on the part of directors and employees of complying with laws of securities companies as well as insufficient internal control systems in securities companies. The directors and employees of securities companies must increase their awareness of the importance of compliance and strive to implement fair business practices. Also, securities companies themselves must work to build effective internal control systems.

As a result of its inspections, the SESC sent recommendations (see Chapter 3) to the prime minister and the commissioner of the Financial Services Agency (FSA) on disciplinary action against 10 securities companies and 70 directors and employees of securities companies for grave violations of the law.

3. Effective market surveillance

The effective collection and accurate analysis of information on securities markets are essential in detecting unfair transactions quickly. To this end, the SESC strives to work closely with SROs and collect information from the general public in addition to checking movements in stock prices.

In the year under review, the SESC conducted surveillance activities in a total of 392 cases: 112 cases of suspected price manipulation, 249 cases of suspected insider trading, and 31 cases of suspected spreading of rumors and other issues.

4. Measures to cope with the progress of information technologies and internationalization

Information technology has rapidly diversified and complicated financial products and, as symbolized by the use of the Internet, has had a significant impact on transaction methods and communication media. To cope with this situation, the SESC enhanced its system of collecting and analyzing information on the Internet through the Internet Patrol System (IPS).

As a result of the rise in the number of securities transactions across borders, the sharing

of information with overseas regulators has become essential in many cases. The SESC has been striving to increase cooperation with overseas regulators on various occasions presented by the International Organization of Securities Commissions (IOSCO) and trying to conclude memorandums of understanding (MOUs) aimed at sharing nonpublic information on a bilateral basis.

Chapter 1: Investigations of Criminal Offenses and Filing of Complaints

Section 1. Outline

1. Purpose and history

The authority to investigate criminal offenses was given to the SESC at its establishment to ensure market fairness and soundness as well as to protect investors. With this authority, the SESC investigate any illegal action that violates securities laws and regulations and calls for criminal prosecution by filing formal complaints with a public prosecutors office.

Investigations of criminal offenses are carried out by the SESC staff under the authority prescribed in the SEL, the Law on Foreign Securities Firms (LFSF), and the Financial Futures Trading Law (FFTL). In contrast, inspections of securities companies and other related financial institutions are conducted under the authority delegated to the SESC by the prime minister and the commissioner of the FSA. Concerning the investigations of criminal offenses, the SESC's authority is not limited to securities companies but reaches all parties involved in securities transactions, including investors themselves.

The SESC may conduct noncompulsory investigations of criminal offenses (Article 210 of the SEL, Article 53 of the LFSF, and Article 106 of the FFTL), including making inquiries about suspects or related parties (hereinafter referred to as "suspects"), the inspection of materials in the possession of or left behind by suspects, and the confiscation of materials supplied to or left behind by suspects. The SESC may also conduct compulsory investigations with warrants from judges (Article 211 of the SEL, Article 53 of the LFSF, and Article 107 of the FFTL). Such investigations include visiting and searching the premises of suspects and seizing related evidence.

2. Scope of criminal offenses and filing of complaints

The scope of criminal offenses is prescribed in relevant Cabinet Orders (Article 45 of the SEL Enforcement Order, Article 23 of the LFSF Enforcement Order, and Article 14 of the FFTL Enforcement Order), including loss compensation, the spreading of rumors, market manipulation, insider trading, and the submission of securities reports containing false information.

The results of criminal investigations are reported to the SESC by its investigators (Article 223 of the SEL, Article 53 of the LFSF, and Article 119 of the FFTL). When convinced of a suspect's guilt, the SESC file a complaint with a public prosecutors office and sends the evidence it gathered in its investigation (Article 226 of the SEL, Article 53 of the LFSF, and Article 122 of the FFTL).

Section 2. Investigations of criminal offenses and filing of complaints

1. Investigations of criminal offenses

During the year under review, compulsory investigations (which include searching the suspect's premises and seizing related evidence) were conducted into transactions involving the shares of Shimura Kako Co. (suspected of market manipulation).

The SESC also exercised its authority to conduct noncompulsory investigations as deemed necessary.

2. Filing of complaints

Based on the results of its investigations, The SESC filed a total of seven complaints with public prosecutors about violations of the Securities and Exchange Law (SEL): three cases of insider trading, one case of market manipulation, and three cases of window dressing.

Case 1: Window Dressing

On December 20, 2001, the SESC filed a complaint with the Osaka District Public Prosecutors Office against Footwork Express Co. and six suspected individuals, including the former president, for window dressing its account report.

On June 7, 2001, the SESC filed a complaint with the Osaka District Public Prosecutors Office against three certified public accountants who were responsible for its audit certificate for violating the SEL (Article 197 (1) (1), "Filing of securities reports containing falsified statements on a material matter").

Six Footwork Express employees—former President Wataru Ohashi, former Vice President Shunji Kuroda, former managing director Hiroyuki Matsumoto, and the three certified public accountants (Toshikazu Matsukawa, Yasuhiro Hiura, and Masato Inoue)—conspired together to pad the company's sales by a combined ¥42.4 billion for three consecutive

years from 1997, though the company had suffered losses, to secure bank loans. Its securities reports for fiscal years 1997, 1998, and 1999 were submitted containing falsified statements that overstated its ordinary profit and current term net profit by a total of ¥27.5 billion each and its inappropriate retained earnings for current term by a total of ¥27.3 billion during this time.

Note: On June 10, 2002, a prosecution against Ohashi, Kuroda, Matsumoto, Matsukawa, Hiura, and Inoue was brought to the Osaka District Court. Two of the certified public accountants, Hiura and Inoue, received a summary order from the court to pay a fine of ¥0.5 million. The case concerning the rest, i.e., Ohashi, Kuroda, Matsumoto, and Matsukawa, is pending public trial.

Case 2: Market Manipulation

On March 20, 2002, the SESC filed a complaint against three suspected individuals with the Tokyo District Public Prosecutors Office for manipulating the stock price of Shimura Kako Co., which is listed on the first section of the TSE, in violation of the SEL (Article 159, "Prohibition of Market Manipulative Acts").

On January 10, 2001, Kazumi Takeuchi and Yoshiki Kuwabara plotted together to boost and manipulate the stock price of Shimura Kako Co., from ¥447 to ¥521, by placing a series of buy market orders or limit orders at higher prices to drive the price up and at lower prices to prevent its market fall with the aim of inducing others to trade its stock.

From January 12, 2001, to January 19, 2001 (six consecutive trading days), Takeuchi, Kuwabara, and Yoshiteru Nishi plotted together to boost and manipulate the stock price of Shimura Kako Co., from ¥546 to ¥719, by placing a series of buy market orders or limit orders at higher prices to drive the price up and at lower prices to prevent its market fall with the aim of inducing others to trade its stock

In addition, for four trading days out of this period, they repeatedly made wash sales and placed matched orders for three trading days with the aim of misleading others as to the state of its trading.

Note: On March 20, 2001, a prosecution against Takeuchi, Kuwabara, and Nishi was brought to the Tokyo District Court. The case is pending public trial.

Case 3: Insider Trading

On March 26, 2002, the SESC filed a complaint with the Tokyo District Public Prosecutors Office against a suspected individual for the insider trading of T&E Soft Inc. stock, which is listed on the JASDAQ over-the-counter market, in violation of the SEL (Article 166 (1) "Prohibited acts of corporate insiders").

Toshiyuki Ishiko, the president of an advertising agency, gained knowledge of a business tie-up involving T&E Soft Inc. with a Disney subsidiary on his business. His agency was responsible for producing the press release on the tie-up. He bought 6,000 T&E Soft Inc. shares for ¥5 million in December, before the announcement. The suspect tried to make a profit by selling the stocks after the announcement.

Note: On July 17, 2002, a prosecution against Ishiko was brought to the Tokyo District Court. The case is pending public trial.

Case 4: Window Dressing

On July 20, 2002, the SESC filed a complaint with the Osaka District Public Prosecutors Office against Nanaboshi Co. and five suspected individuals, including a former chairman, for window dressing its account report in violation of the SEL (Article 197 (1) (1), "Filling of securities reports containing falsified statements on a material matter").

The former Nanaboshi chairman, former board director, and three other incumbent executive officers conspired together to pad the company's sales by ¥5.9 billion for fiscal years 2000 and 2001 by appropriating a fictitious deposit paid for construction work. As a result, its securities reports for fiscal years 2000 and 2001 were submitted containing falsified statements that overstated its ordinary profit and current term net profit by a total of ¥1.1 billion each.

Case 5: Insider Trading

On June 28, 2002, the SESC filed a complaint with the Tokyo District Public Prosecutors Office against two suspected individuals for the insider trading of Mikasa Coca-Cola Bottling Co. stock, in violation of the SEL (Article 167 (1), "Prohibited acts of bidder or

associated person"). (The two suspects in this case are the same as those mentioned in case 7.)

One of the suspects, a former Bank of Tokyo-Mitsubishi employee who worked at the investment banking section, gained knowledge of Coca-Cola West Japan Co.'s decision to make a takeover bid for Mikasa Coca-Cola Bottling Co. when the bank concluded an advisory contract with Coca-Cola West Japan Co. Late in February 2000, he bought 5,000 Mikasa Coca-Cola Bottling Co. shares for ¥4 million under the name of his friend before the announcement of the takeover bid in order to make a profit by selling the stocks after the announcement.

Case 6: Insider Trading

On June 28, 2002, the SESC filed a complaint with the Tokyo District Public Prosecutors Office against two suspected individuals for the insider trading of Sanyo Pax Co. stock in violation of the SEL (Article 167 (1), "Prohibited acts of bidder or associated person"). (The two suspects in this case are the same as those mentioned in case 7)

One of the suspects, a former Bank of Tokyo-Mitsubishi employee who worked at the investment banking section, gained knowledge of Sanyo Engineering Co.'s decision to make a takeover bid for Sanyo Pax Co. From late March to early April, he bought 10,000 Sanyo Pax Co. shares for ¥5 million under the name of his friend before the announcement of the takeover bid to make a profit by selling the stocks after the announcement.

Note: The names of suspects in cases that were not brought to court at the time this SESC annual report was being prepared is not disclosed.

Chapter 2: Inspections

Section 1. Objective and scope of SESC inspections

The SESC conducts on-site inspections of securities companies and related organizations to confirm their compliance with laws and regulations and ensure fairness in securities transactions. SESC inspections are carried out under the authority delegated to the SESC by the prime minister and the commissioner of the FSA as prescribed in the SEL, LFSF, and FFTL.

The objective of SESC inspections is to protect the public interest and investors. SESC inspections are expected to support the prime minister and the commissioner of the FSA in taking necessary measures and formulating policies concerning securities companies.

The following institutions are subject to SESC inspections:

- Securities companies and their holding companies
- Registered financial institutions that provide securities services and its parent companies
- Securities dealers associations
- Stock exchanges
- Branches of foreign securities companies and specified financial institutions
- Financial futures exchanges and their members
- Financial futures dealers
- Financial futures associations (FFAs)

The scope of SESC inspections is regulated by the Cabinet Orders (Article 38 of the SEL Enforcement Order, Article 20 of the LFSF Enforcement Order, and Article 9 of the FFTL Enforcement Order). For example, the SESC is authorized to conduct inspections on the suspicion of violations of securities laws and regulations, including the conclusion of discretionary account contracts, representation of decisive predictions, and solicitations with promises of special profits, by securities companies and their directors or employees as well as such violations as profit guarantees and loss compensation, market manipulation, and insider trading.

Section 2. Basic policy and plan for inspections

Inspection periods are based on SESC years (from July 1 to June 30 of the following year). At the beginning of the SESC year, basic policies and plans for inspections are made to ensure that all inspections by the SESC and those by regional offices are managed and conducted fairly as well as efficiently.

Important inspection items and other basic matters are determined in the basic policy for inspections. The basic plan for inspections states the number and types of securities companies that the SESC is to inspect that year.

Section 3. Results of inspections

1. Outline

During the year under review, the SESC and regional offices commenced the inspection of 96 securities companies and seven registered financial institutions.

Of this total, the SESC commenced the inspection of ten domestic securities companies, 14 branches of foreign securities companies, two registered financial institutions, and two SROs. Regional offices commenced the inspection of 72 domestic securities companies and five registered financial institutions.

Regarding inspections that were commenced during the year under review, inspections were completed on 65 domestic securities companies, eight branches of foreign securities companies, and five registered financial institutions with the presentation of a Notice of Conclusion to the companies (see Table 1). In addition, 11 inspections that were commenced in SESC year 2000 but were not completed by June 30, 2001, were all completed during the year under review.

Following SESC recommendations based on inspections concluded in SESC year 2001 (including those that were commenced in the previous year), the prime minister and the commissioner of the FSA took disciplinary actions against 10 securities companies for their grave violations of laws and regulations (see Chapter 3).

Problems uncovered in these inspections were reported by the SESC to the supervisory sections of the FSA, which then issued directives for improvement to the securities companies inspected.

In SESC year 2001, the SESC conducted inspections of financial futures dealers along with these of securities companies.

Table 1: Inspection

Categories	SESC Year 1997	SESC Year 1998	SESC Year 1999	SESC Year 2000	SESC Year 2001
Securities companies	79	80	86	96	96
Domestic (SESC) (Regional offices)	72 (7) (65)	68 (6) (62)	82 (9) (73)	72 (6) (66)	82 (10) (72)
Foreign (SESC) (Regional offices)	7 (7) (0)	12 (12) (0)	14 (14) (0)	14 (14) (0)	14 (14) (0)
Branch inspections	31	27	28	27	21
Registered financial institutions (SESC) (Regional offices)	0 (0) (0)	0 (0) (0)	0 (0) (0)	3 (2) (1)	7 (2) (5)
Financial futures dealers (SESC) (Regional offices)	1 (0) (1)	0 (0) (0)	0 (0) (0)	0 (0) (0)	0 (0) (0)
SROs (SESC) (Regional offices)	1 (1) (0)	0 (0) (0)	0 (0) (0)	0 (0) (0)	2 (2) (0)

Notes: 1. The above figures are the number of inspections that was commenced.

2. The category "Branch inspections" shows the number of inspections conducted only on branches by regional offices.

3. Before December 1998, registered financial institutions were financial institutions licensed to provide securities business.

2. Results of inspections of securities companies

Inspections of securities companies in the year under review were conducted mainly to confirm their compliance with laws and rules, sales practices, and internal control systems. Another important focus was to confirm that problems uncovered in previous inspections were corrected.

Among the 90 companies that were inspected, problems were uncovered in 57 companies. Out of the 57, inspections uncovered violations of laws and rules in 39 companies. Inspections also revealed many problems related to the sales practices and internal control systems of securities companies.

In the year under review, the SESC uncovered a particularly large number of serious violations of laws, for which the SESC made recommendations to the prime minister and

the commissioner of the FSA. These are believed to have been caused by a lack of awareness among directors and employees of the importance to comply with laws and rules as well as insufficient internal control systems. It is necessary that the directors and employees of securities companies strengthen their awareness of the importance of compliance and strive to implement fair business practices and that securities companies themselves build effective internal control systems.

As for problems related to compliance with market rules, the SESC uncovered violations of laws, such as conclusions of discretionary account contracts, securities transactions for speculative profit by directors or employees, and numerous instances of violations of self-regulatory rules. During the year under review, the SESC also uncovered vicious illegal activities, such as short selling in violation of Cabinet Orders (failure to indicate and confirm short selling and the execution of short selling below the price at the last reported sale), the giving of false or misleading information related to securities and other trading, and a series of transactions to create an artificial market.

As for problems related to sales practices, there were cases in which the customer's profit was substantially ignored and insincere or unfair acts were conducted in solicitations. They included solicitations of mutual fund switching in the short term without sufficient explanation and insufficient explanations on the price information of covered warrants. The SESC proposed that the commissioner of the FSA take necessary and appropriate measures to correct these sales practice (see Chapter 4).

As for internal control systems, although securities companies adopted measures to strengthen their systems, such measures were not enough to do so. They included a case in which an internal administrator failed to detect illegal transactions, a case in which a sales manager failed to detect illegal activities because he gave priority to only customer problems when he decided to visit them, a case in which a sales manager detected a violation of laws other than customer problems but did not report it to an internal administrator because he did not take them seriously, and a case in which the lack of an in-house training program on compliance allowed a sales representative to inappropriately accept orders.

These examples illustrate the fact that the internal control systems of these companies

were carried out in an insufficient or inappropriate manner, thereby making the systems ineffective, and that the people involved in controlling these systems lacked the awareness of the importance of complying with laws and regulations.

The following is a summary of the problems uncovered in inspections completed in SESC year 2001, including those commenced in the previous SESC year.

(1) Concerning compliance with transaction rules, the following problems were found in some securities companies:

Violations of laws that resulted in recommendations

Conclusion of discretionary account contracts

Representation of false or misleading statements on any material matter in connection with securities transactions

Solicitations with the promise of special profit to a customer

A series of transactions to create an artificial market without any reflection of the actual state of the market and the acceptance of orders for such series of transaction with the knowledge that they will form an artificial market

Insufficient internal control on securities transactions from the standpoint of preventing unfair trading based on information on corporations that a securities company obtained

short selling in violation of Cabinet Orders (failure to indicate and confirm short selling and the execution of short selling below the price at the last reported sale)

Inappropriate business practices for a securities company

Securities transactions for speculative profit by the directors or employees of securities companies

Provision of property benefits to compensate for losses

Grossly inappropriate behavior of sales representatives concerning their duties

Violations of laws that did not result in recommendations

Representation of false or misleading statements on any material matter related to the sale of EBs

Representation of false or misleading statements on any material matter related to the sale of dual currency bonds during a offering period

Purchase of a security involved in stabilizing transactions during its stabilizing period
its own account

Violation of self-regulatory rules

Skewing the number of demanded securities in a demand research for IPOs

Failure to explain to a customer that the disclosure requirement under the SEL does
not cover foreign securities

Unauthorized transactions

Receiving an order from an employee of another securities company without
obtaining a written consent from the other securities company

Acceptance of orders for trading under a fictitious name

Borrowing of the customer's name by sales representatives

Lending money to and borrowing money from customers by sales representatives

²¹ Advertisements by sales representatives without the permission of a compliance
officer

(2) Concerning sales practices, the following problems were found in some securities
companies:

Solicitations of switching mutual funds in the short term without sufficient explanation

Insufficient explanations on the price information of covered warrants

Solicitations of switching mutual funds within the same family fund, which causes the
customer to pay unnecessary sales commissions

(3) Concerning internal control systems, the following problems were found in some
securities companies:

Insufficient internal control systems and insufficient operation of internal control
systems

Insufficient awareness by directors and employees of the importance of compliance
with laws and regulations

3. Results of inspections of registered financial institutions

Inspections of registered financial institutions were conducted concerning their compliance
with transaction rules, sales practices, and internal control systems. As a result of those
inspections, the SESC discovered that some financial institutions asked their customers to

bear the losses caused by operational failure (Sanwa Bank).

4. Results of inspections of financial futures dealers

Inspections of financial futures dealers were conducted concerning their compliance with transaction rules and the realities of sales practices in soliciting investments, etc. However, no specific problems were uncovered in the inspections.

5. Results of inspections of SROs

On April 18, 2002, the SESC and FSA informed the TSE and OSE of their respective inspection in advance. The inspection of the TSE commenced on May 8, 2002, and the inspection of the OSE on May 9, 2002.

These inspections were conducted to comprehensively confirm their financial soundness and business practices, particularly because of the fact that the TSE and OSE changed from a membership organization to a stock corporation in the previous year, and their responsibilities as a self regulatory increased.

Chapter 3: Recommendations

Section 1. Outline

Based on the results of inspections and investigations of criminal offenses, the SESC may, if necessary, send recommendations to the prime minister and the commissioner of the FSA on disciplinary actions or other appropriate measures (hereinafter “disciplinary actions”) to ensure fairness in securities transactions (Article 20 (1) of the FSA Establishment Law (FSAEL)).

For example, the SESC is authorized to make recommendations on administrative disciplinary actions to be taken against securities companies that violate laws as well as recommendations requesting that SROs take necessary actions against securities companies that violate laws when the SROs have failed to do so even though the violation had been identified.

The SESC may request that the prime minister and the commissioner of the FSA report on actions taken based on the SESC’s recommendations (Article 20 (2) of the FSAEL).

After receiving recommendations on disciplinary actions based on the results of inspections made by the SESC, the prime minister and the commissioner of the FSA hold hearings with the parties involved and take disciplinary actions, such as revoking the registration of securities companies or suspending their operations, when deemed necessary.

Because the JSDA is entrusted with administrative work related to the registration of sales representatives (Article 64-7 (1) of the SEL), the JSDA, based on SESC inspection results, holds further hearings with the parties concerned and takes such measures as revoking the registration of sales representatives or suspending their operations.

Section 2. Recommendations and actions taken

In the year under review, based upon the results of inspections and investigations, the SESC sent 34 recommendations to the prime minister and the commissioner of the FSA on disciplinary actions against securities companies and directors or employees of securities

companies.

The number of recommendations calling for administrative disciplinary actions against securities companies was 18. A total of 47 directors and employees were referred to in the SESC recommendations.

Violations of laws referred to in the recommendations are as follows:

1. Violations of laws by companies

Conclusion of discretionary account contracts (violation of Article 42 (1) (v) of the SEL)

○ Eleven Century Securities Co. (Century) employees, including an Ageo branch manager, concluded discretionary account contracts with clients and conducted related stock transactions, option transactions, and futures transactions.

These actions were regarded as the company's because the improper compliance system of Century allowed the misconduct of its employees to happen.

- Recommendation date: April 2, 2002
- Disciplinary action: A three-day suspension of business operations, a suspension of business at sections in its head office and each branch office directly related to the misconduct, and the drastic, mandatory improvement of its compliance system

Note: These disciplinary actions were imposed not only for conclusion of discretionary account contracts but also for other misconducts by the company, such as representation of false or misleading statements on any material matter in connection with securities transactions, and inappropriate business practices for a securities company.

○ Twenty-one employees of Mito Securities Co., Ltd., and a section chief of the Head Office equity sales department, in concluded discretionary account contracts with clients and conducted related stock transactions.

In addition, 11 employees other than the 22 mentioned above concluded discretionary account contracts with clients, which did not result in recommendations as an individual act. The company failed to supervise its 33 employees, allowing this misconduct to happen. Thus, it was regarded as a company act.

Note: The misconduct of the 11 employees did not result in a recommendation.

- Recommendation date: June 28, 2002
- Disciplinary action: A four-day suspension of a section of business at its head office and each branch office directly related to the misconduct and the drastic, mandatory improvement of its compliance system

Representation of false or misleading statements on any material matter in connection with securities transactions (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL, including the application of Article 14 (1) of the LFSF)

○ From April 2000 to September 2001, Tubasa Securities Co., Ltd., (Tubasa) sold foreign stocks and foreign bonds to many individual investors.

Selling those foreign securities, Tubasa distributed explanatory notes as sales material that contained false or misleading statements on material matter; for instance, annual net income per share or the rating of bond issuers.

- Recommendation date: November 9, 2001
- Disciplinary action: The mandatory improvement of its compliance system

○ From December 2000 to January 2001, Century Securities Co., Ltd., (Century) continued to sell EBs even after the initially scheduled offering periods at the same prices as the fixed initial sales prices, which were much higher than the appropriate current prices estimated using the market price of its reference stock.

Recommendation date: April 2, 2002

Disciplinary action: A three-day suspension of business operations, etc.

Note: An EB is a kind of structured bond that contains an obligation of seller of put options of reference stocks. EBs are sold to both retail and institutional investors in Japan. Normally, the maturity term of an EB is three to six months, and its interest rate is rather high compared to common bonds due to its premiums.

Unlike common bonds, its principal is not necessarily redeemed in full in cash. If the reference stock price (or reference index) at a fixing date that might be a couple of days before its maturity date falls below a predetermined price, then the EB gets redeemed for the underlying securities with unrealized losses.

○ From September 1999 to April 2000, Cosumo Securities Co., Ltd., (Cosumo) offered EBs, of which the underlying stock prices declined substantially lower than the strike price of the EBs, and there was no economic benefit of purchasing the EBs compared to investing directly in reference stocks by the end of its offering periods.

Under these circumstances, Cosumo failed to provide an explanation of these unfavorable pricing conditions of EBs when offering them.

- Recommendation date: June 11, 2002
- Disciplinary action: Mandatory improvement of its compliance system

Note: Here is an extreme example of the “no economic benefit transaction of EBs.”

Amount of investment: ¥1 million

Execution price: ¥1,000

Reference stock: X Company

Coupon: 5% (annual rate)

Term: 3 months

Redemption: Physical delivery (1,000 shares of X Company stock) or cash delivery of ¥1 million

X Company's stock price at the time investors buy EBs is ¥800

1. If the market price of X Company at redemption is ¥1,200 (cash delivery)

Profit of investment in EB $1 \text{ million} \times 0.05 \div 4 = ¥12,500$

Profit of investment in X Company's stock $1,250 \text{ shares} \times ¥12,000 - 1 \text{ million} = ¥500,000$

2. If the market price of X Company at redemption is ¥500 (physical delivery)

Loss of investment in EB $1,000 \text{ shares} \times ¥500 - 1 \text{ million} + ¥12,500 = ¥487,500$

Loss of investment in X Company's stock $1 \text{ million} - 1,250 \text{ shares} \times ¥500 = ¥375,000$

Like above, whatever the price at maturity is, investment in EB results in less profit or more loss than investment in reference stock

Solicitations with promises of special profits (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL, including the application of Article 14 (1) of the LFSF)

In May 1998, Yutaka Securities Co., Ltd., (Yutaka) with the involvement of a manager of its Tokyo branch and a commission sales representative, solicited the transactions of securities based on promises that Yutaka would offer a part of the sales representative's commission as a kickback to the person who had discretionary power on the order execution of an institutional customer.

In June 1998, Yutaka, with the involvement of an executive director and a manager of its Tokyo branch, solicited the transactions of securities based on promises that Yutaka would offer monetary profits as a kickback to the person who had discretionary power on the order execution of an institutional client.

On March 10, 1999, Yutaka, with the involvement of a commission sales representative, solicited the transactions of securities based on promises that Yutaka would offer monetary profits as a kickback to the person who had discretionary power on the order execution of an institutional client to keep up the good relationship it had with the client.

Recommendation date: August 3, 2001

Disciplinary action: A 10-day suspension of stock brokerage operations at its Tokyo branch

A series of transactions to create an artificial market without any reflection of the actual state of the market and the acceptance of securities transaction orders with the knowledge that it will form an artificial market (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL, including the application of Article (1) of the LFSF)

On December 4, 2001, Morgan Stanley Japan Ltd. (Morgan Stanley), with the involvement of a trader from the Japanese equity division and a trader from the derivatives market division, drove down the stock price to a level that would enable Morgan Stanley to sell the stock short by selling the stock at a lower price than the stock's quotation, established immediately before it sold them short

Recommendation date: January 30, 2002

Disciplinary action: A 5-week suspension of proprietary trading of equity

Note: Disciplinary actions were imposed not only for A series of transactions to create an artificial market without any reflection of the actual state of market and the acceptance of securities transaction orders with the knowledge that they will form an artificial market but also for Morgan Stanley's other misconduct mentioned in Failure to indicate and confirm short selling and the execution of short selling by down tick in violation of Cabinet Orders.

○ E * Trade Securities Co. (E * Trade), with the involvement of a chief of its financial management division, accepted and executed a series of transaction orders for Shimura Kako from a suspect who was arrested in February for manipulating the company's stock, knowing the suspect's intention to create an artificial market.

These actions were regarded as the company's because the improper compliance system of E * Trade allowed the misconduct of its employees .

Recommendation date: June 13, 2002

Disciplinary action: A five-day suspension of brokerage of equity at its sales advisory department and the mandatory improvement of its operations .

Insufficient internal control on securities transactions from the standpoint of preventing unfair trading based on information on corporations that a securities company obtains (violation of a Ministerial Ordinance, Article 43 (2) of the SEL)

○ Sakura Friend Securities Co., Ltd., (Sakura Friend) set a policy of controlling undisclosed information on its corporate clients. Sakura Friend also separated the section that was in charge of repurchase plans from the section that was in charge of proprietary trading. However, it did not work properly to control undisclosed information that could result in insider trading. In some cases, the trader who was in charge of the company's proprietary trading had a chance to accept a series of buy orders from a listed company for its repurchase plan. The situation allowed the trader to gain access to the company's repurchase plan.

In one particular case, which happened on July 12, 2000, the same trader executed an order of the company's shares for Sakura Friend's own account even after the trader gained knowledge of the company's undisclosed information. These cases demonstrated Sakura Friend's insufficient internal control of undisclosed information on its corporate clients.

Recommendation date: April 23, 2002

Disciplinary action: The mandatory improvement of its operations

Short selling in violation of Cabinet Orders (Failure to indicate and confirm short selling and the execution of short selling below the price at the last reported sale).

○ From November 14, 1998, to July 31, 2001, Goldman Sachs (Japan) Ltd. failed to report to a stock exchange its short selling activities in 2,368 cases.

Recommendation date: December 19, 2001

Disciplinary action: A 10-day suspension of proprietary trading of equity

A 5-day suspension of credit derivatives trading, etc., which
used to be conducted without the approval of the FSA

The mandatory improvement of its operations

Note: Disciplinary action was also imposed for the illegal activity uncovered by the FSA.

○ From December 2001 to February 2002, Morgan Stanley Japan Limited (Morgan Stanley) conducted a number of short selling activities for its own account without reporting it to stock exchanges, and in some cases, they executed the short selling below the price at the last reported sale.

Recommendation date: January 30, 2002

Disciplinary action: A 5-week suspension of proprietary trading of equity, etc.

○ From April 2001 to February 2002, Dresdner Kleinwort Wassserstein (Japan) (Dresdner Kleinwort Wassserstein Securities) accepted sell orders from customers without confirming whether the sale was short or not and failed to report it to stock exchanges.

From December 2001 to February 2002, Dresdner Kleinwort Wassserstein Securities conducted a number of short selling activities for its own account without reporting it to stock exchanges, and in some cases, em they executed the short selling below the price at the last reported sale.

Recommendation date: June 7, 2002

Disciplinary action: A 10-day suspension of brokerage operations of equity for
affiliate companies

A 5-day suspension of credit derivatives trading, etc., which
used to be conducted without the approval of the FSA

The mandatory improvement of its operations

Note: The misconduct, for which the disciplinary action was imposed, includes A series of transactions to create an artificial market without any reflection of the actual state of the market and the acceptance of securities transaction orders with the knowledge that they will form an artificial market.

Inappropriate business practices for a securities company

The inspection of Century securities revealed a number of cases of misconduct, as in the previous inspection. The misconduct resulted from the following factors.

Even after receiving the order to improve the company's operations based on the previous SESC inspection, the president of Century put the compliance issues behind the sales activity so that Century did not take sufficient measures in terms of organization and budget for compliance, which allowed Century to continue committing the same kind of violations as before. Also, the executive officers lacked compliance awareness, and some of them falsified the number of customer visits, which encouraged a recurrence of illegal acts.

An internal administrator supervisor delegated his duties to a subsidiary internal administrator.

The internal administrator supervisor did not direct or supervise the subsidiary internal administrator, a sales manager, or internal administrator.

These situations illustrated the fact that Century operated its business in an inappropriate manner for a securities company.

Recommendation date: April 2, 2002

Disciplinary action: A 3-day suspension of business

Note: These disciplinary actions were imposed not only for inappropriate business practices for a securities company but also for conclusion of discretionary account contract and representation of false or misleading statements on any material matter in connection with securities as mentioned before.

2. Violations of laws by directors and employees

In the year under review, the SESC made recommendations against directors and employees (registered sales representatives) of securities companies concerning the following violations of laws:

Speculative securities transactions by directors or employees (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL)

Sales representatives conducted trading in stocks on their own judgment on many

occasions by using customers' accounts in order to increase sales performance and pursue their own profits.

(Recommendations made against eight companies and nine individuals)

Provision of property benefits to compensate for losses (violation of Article 42 (2) (i) 3 of the SEL)

A sales representative gave up a part of the money that he paid temporarily for his customer's transactions in order to partially compensate for the customer's losses that resulted from its securities transactions and, thus, providing property benefits.

(Recommendations made against two companies and two individuals)

Grossly inappropriate behavior of sales representatives concerning their duties (violation of Article 64 (5) (i) 2 of the SEL)

A sales representative used the names and addresses of his customers in order to subscribe to a book building of IPOs and bought and sold the IPO shares allocated to him in pursuit of his own profit.

He also advised his relatives to subscribe to a book building of IPOs under his customers' names. In some cases, he paid for the transaction instead of his relatives, and in other cases, he offered a joint account for his relatives.

(Recommendations made against one company and one individual)

Note: A series of acts done by the sales representative fell under several prohibited acts prescribed under the JASD rule "Fair business practice," no. 8, Article 9 (e.g., joint account with a customer and the use and allowing the use of names and money). Considering the nature of the act, it came under the Article 64 (5) (i) 2 of the SEL.

Chapter 4: Proposals

Section 1. Outline

Based on the results of inspections and investigations of criminal offenses, the SESC may, if necessary, give proposals to the prime minister, the commissioner of the FSA, and the Minister of Finance to ensure fairness in securities transactions (Article 21 of the FSAEL).

Proposals are designed to present the SESC's comprehensive analyses of incidents uncovered in its inspections and investigations and its view on how laws and self-regulatory rules should be amended so that they will be reflected in various measures to be taken by the administration and SROs. Proposals given by the SESC are important materials to be used in making judgments when administrative departments prepare their policies.

Section 2. Proposals

During the year under review, the SESC did not find any cases that needed to be proposed to the prime minister, the commissioner of the FSA, or the Minister of Finance on the basis of the results of inspections and investigations of criminal offenses.

Chapter 5: Market Surveillance

Section 1. Outline

In addition to inspections and investigations related to violations, the SESC conducts market surveillance as part of its regular activities. The objective of market surveillance is to ensure fairness in securities transactions and the protection of investors. These activities are carried out under the authority delegated by the prime minister and the commissioner of the FSA as prescribed in the SEL, LFSF, and FFTL. The SESC conducts the day-to-day monitoring of market activities by requesting detailed reports on securities transactions from securities companies and collecting relevant materials for market surveillance.

Institutions from which reports and materials are collected are listed as follows:

- Securities companies and their holding companies
- Registered financial institutions that provide securities services
- Securities dealers associations
- Stock exchanges
- Branches of foreign securities companies and specified financial institutions
- Financial futures exchanges and their members
- Financial futures dealers
- FFAs

The SESC also maintains close relationships with the market surveillance sections of SROs, including stock exchanges and the JSDA, by sharing necessary information on a regular basis or upon request or by making references to factual information.

Section 2. Market surveillance

1. Market surveillance

Market surveillance activities include gathering information on markets and companies, collecting materials from securities companies, and conducting hearings. Through these activities, close analyses of specific market transactions are conducted for certain periods.

Details of market surveillance conducted during the year under review are as follows:

(1) Related to market manipulation	112 cases
• Sharp stock price rises	108 cases
• Pegged stock price movements	3 cases
(2) Related to insider trading	249 cases
• Downward revision of earnings estimate	63 cases
• Upward revision of earnings estimate	29 cases
• New share issues	25 cases
(3) Others, including the spreading of rumors	31 cases

Cases of market surveillance conducted by the SESC and regional offices are as follows:

Conducted by the SESC	270 cases
Conducted by regional offices	122 cases

2. Summary of surveillance results

The results of market surveillance conducted during the year under review can be summarized as stated below:

Surveillance concerning market manipulation was centered on sudden stock price rises and other unnatural movements. Stocks that were under surveillance due to sudden price rises included stocks that seemed to be traded by certain groups of investors in a disguised and collaborative manner with the intention of raising stock prices.

Surveillance concerning insider trading focused on cases in which stock prices fluctuated significantly upon the announcement of information that seemed to have a considerable impact on the decisions of investors. These included a considerable amount of information that would cause prices to rise, such as the announcement of revisions to earnings estimates and new stock issues. Cases concerning the suspicion of insider trading involved the directors and employees of companies that have business relationships with issuers in addition to the directors and employees of the issuers.

Surveillance concerning the spreading of rumors centered on stock information on the Internet as well as suspicious trades related to the September 11 attacks on New York and Washington.

Cases that required further investigation would be dealt with by conducting on-sight inspections, etc.

Regular securities market surveillance through these activities is considered to function as a direct or indirect deterrent to unfair transactions.

Chapter 6: Seeking/Receiving information from the general public

Information provided from the general public is useful in inspections, market surveillance activities, and investigations of criminal offenses. The SESC established a system for receiving such information and has been actively seeking information from the general public.

The SESC receives information by telephone, mail, personal visits, and over Internet. The amount of information received has rapidly increased over the last couple of years. Such information is passed on to and used by sections conducting inspections, market surveillance, investigations of criminal offenses, and regional offices. Some of them were essential clues on which inspections and investigations started.

Disputes between securities companies are also a useful source of information for SESC inspections, but the SESC does not have power to solve individual cases. Therefore, when the SESC receives this kind of information, it directs the clients to JSDA's investor complaints center.

In the year under review, the number of pieces of information the SESC received hit a record high of 2,181, up approximately 60% from the previous year. The amount of information received over the Internet, in particular, more than double from that in the previous year. A breakdown of the information is as follows: 1,282 from Internet feedback, 406 over the telephone, 60 from visits, 291 by mail, and 142 forwarded from the FSA and regional offices. By type of information, 1,208 pieces were related to specific stocks, 498 were related to the sales practices of securities companies, and 475 were opinions directed to the SESC.

Out of the information related to specific stocks, that concerning suspected market manipulation was the most frequently seen. This was followed by information concerning the suspected spreading of rumors and suspected insider trading. Half of the information can be categorized into the three mentioned above, which reflects the investor's suspicion of the markets.

Among the information concerning the sales practices of securities companies, cases of

unauthorized transactions and solicitations with decisive predictions were the most frequently seen (see Table 2).

Table 2: Information Received (Last Four Years)

Methods

	SESC Year 1998	SESC Year 1999	SESC Year 2000	SESC Year 2001
Internet	49	359	606	1,282
Telephone	77	198	390	406
Mail	55	156	205	291
Visits	21	19	64	60
Forwarded from the FSA and regional offices	39	57	91	142
Total	241	789	1,356	2,181

Contents

	SESC Year 1998	SESC Year 1999	SESC Year 2000	SESC Year 2001
Specific stocks	147	385	671	1,208
Market manipulation	51	162	317	601
Spreading of rumors on stock market	29	68	124	294
Insider trading	32	90	122	195
Submission of false securities reports	11	39	85	90
Profit guarantee and loss compensation	10	15	8	9
Others	14	11	15	19
Sales practices of securities companies	66	200	356	498
Unauthorized transactions	15	16	35	65
Solicitations with decisive predictions	5	7	35	49
Unsuitable recommendations	3	21	17	13
Conclusion of discretionary account contracts	7	6	49	27
Large-volume recommendation sale	2	3	5	1
Others	34	147	215	343
Others, including opinions, etc., directed to the SESC	28	204	329	475
Total	241	789	1,356	2,181

Note: The SESC year is from July 1 to June 30 of the following year.

Chapter 7: Others Activities

Section 1 Strengthening surveillance systems

1. Staff Increase

The SESC strengthened its surveillance system to boost its ability as a securities industry regulator.

The number of staff as of the end of SESC year 2002 is 182, which is 61 more than that in the previous year. The breakdown is as follows: 20 staff for the inspection of securities companies, 17 for market surveillance, 22 for the investigation of criminal cases, and 2 for dealing with information from the general public.

Also, the number of staff at regional offices increased from the previous year by 39. The total number of staff at the SESC and regional offices is 182, which is 100 more than that in the previous year.

2. Organizational Change

The office of inspection consists of four inspection teams: one in charge of major domestic securities companies, one in charge of medium-sized domestic securities companies and on-line brokers, one in charge of foreign securities companies, and one whose main task is to deal swiftly with incidents. Staff who were employed from the public sector, such as banks and securities companies, are put into each team.

The Section of Market Surveillance was upgraded to the Office of Market Surveillance to efficiently manage and analyze an increasing amount of information from SROs and information obtained by its market surveillance room. Also a new team that is to respond quickly to issues in stock markets was newly-established in the office.

As a result, the Office of Market Surveillance now consists of four teams: one in charge of information, one in charge of stock price manipulation, one in charge of insider trading, and one whose main task is to deal swiftly with incidents.

3. SCAN-System

Since 1993, the SESC has been developing its Securities Comprehensive Analyzing System (SCAN-System), which can be broadly utilized in securities company inspections, market surveillance, and investigations of criminal offenses.

The SCAN-System is divided into two parts: the Securities Company Inspection System and the Market Surveillance System.

(1) Securities Company Inspection System

This system assembles various kinds of financial data concerning securities companies and the outline of inspection results for the analyses of the inspections of securities companies. This system has been in operation since 1995.

(2) Market Surveillance System

This system makes it possible, in the course of preparing basic data, to conduct the surveillance of insider trading, market manipulation, and other activities as well as to make a quick and comprehensive reference to listed or over-the-counter stocks showing unnatural price movements and the content of announcements of important facts and transactions. This system has been in operation since 1997.

The SESC has continued to develop the SCAN-System in order to further improve its functions. In the year under review, the SESC developed surveillance by the technical analysis of corporation finance (STAF) to more efficiently analyze false financial reports submitted by stock issuing companies. The SESC also strengthened the function of the IPS to the complete surveillance of various pieces of information on the Internet.

Section 2. Dealing with Internet trading

1. Outline

With the rapid development of information technology in recent years, the number of Internet users in Japan has increased dramatically, and an enormous number of websites have been created. The Internet is becoming a new means of information transmission.

In addition, the increase in Internet use for securities transactions, which was prompted partly by the liberalization of brokerage commissions, increased the importance of market surveillance of unfair trading over the Internet.

In response to the changing environment surrounding securities transactions, the SESC positioned its staff in charge of the day-to-day collection and analysis of various pieces of information that are posted on bulletin boards or websites on the Internet. The SESC also inspected securities companies to understand the reality of Internet trading.

2. Inspections of securities companies that carry out transactions over the Internet

The SESC inspects securities companies that carry out transactions over the Internet, focusing on such internal controls of the companies as trading and transaction management.

In the year under review, there was one company whose internal control of its customer confirmation procedure over the Internet was insufficient.

3. Internet surf day

The Internet causes dramatic changes in securities markets and makes it easier for investors to obtain more information. On the other hand, the Internet creates new methods of conducting illegal activities in securities markets.

In light of this, on December 19, 2001, the SESC created a program and conducted an Internet surf day to determine the state of illegal activities on the Internet. On that day, the Head Office staff in charge of the Internet and 20 staff at regional offices looked at a total of 2,000 Internet sites related to securities transactions in view of insider trading and spreading rumors. The SESC found a total of 48 sites that required further investigation.

In addition, the SESC took part in the Internet surf day coordinated by the IOSCO in March 2000 and In April 2001.

4. Internet surveillance system

There is an increasing possibility of false information designed for market manipulation being circulated on the Internet.

Because it is difficult for the SESC to check such information with a limited number of staff, the SESC has developed two systems to carry out efficient surveillance.

One is the Internet Patrol System (IPS) and the other is the Internet Data Center (IDC).

The IPS conducts the automatic and regular patrol of specified websites to collect and accumulate information and permits the retrieval of information on specified issues as the need arises. The IDC picks up the more dubious information by using an unspecified number of keywords. Furthermore, the SESC is developing a new system that combines the function of the IPS and IDC.

Note: The IOSCO is an international forum that promotes international harmonization in securities regulations and cooperation among securities regulators. As of December 2002, 177 institutions from 101 countries, provinces, and regions around the world are members of the IOSCO. The SESC joined the IOSCO in October 1993.

Section 3. Cooperating with foreign regulatory authorities

Along with the internationalization of securities transactions, there has been cross-border misconduct affecting fairness in markets around the world. As a result, international cooperation in the field of law enforcement has become increasingly important in ensuring fairness in domestic markets.

Taking this situation into consideration, the SESC continued to actively promote international cooperation in the year under review by, for example, exchanging opinions with various foreign securities regulators regarding law enforcement.

1. Relationship and cooperation with foreign regulatory authorities

In order to promote the reform of Japan's securities markets and improve its surveillance system, it is necessary to understand the regulations of other countries. The SESC promotes the sharing of information on vital issues with foreign regulators at the annual IOSCO meeting and through individual interviews at various levels.

With the globalization of the market and the lingering low interest rate in recent years, new financial devices made by the application of advanced derivative techniques began to be sold to public investors. As investor needs diversify, various financial devices are offered to

investors that, on the one hand, are expected to enhance market effectiveness and, on the other, include potential risks.

2. MOUs

As a result of the internationalization of securities transactions, the need to share information with foreign regulators is increasing for SESC investigations of unfair trading practices. Therefore, it is necessary for regulators in Japan to conclude MOUs in order to share nonpublic information with foreign regulators.

In the year under review, MOUs with the Monetary Authority Singapore were concluded in December 2001, and MOUs with the U.S. Securities and Exchange Commission and U.S. Commodity Futures Trading Commission were concluded in May 2002.

Chapter 8 : Self-Regulatory Organizations

Section 1. Relationship between the Securities and Exchange Surveillance Commission and self-regulatory organizations

SROs (the JSDA, stock exchanges, the FFA, and the TIFFE) make self-regulatory rules and conduct surveillance activities of their members and trading participants (hereinafter “members”) concerning whether member companies operate appropriately in accordance with laws, regulations, and self-regulatory rules in order to ensure fairness in and the transparency of the markets. When conducting surveillance, SROs operate in close cooperation with the SESC (see Diagram 4 on page 49).

The SESC is also in a position to make inspections to judge whether SROs are conducting surveillance in the appropriate manner and whether they are taking proper actions against members who violate laws, regulations, and self-regulatory rules. Having market intermediaries as members, SROs establish frameworks for acceptable conduct and demand that their members comply with regulations, and are thus in a position to enhance investors’ confidence in markets and intermediaries. Through their efforts, SROs bring greater benefits to market intermediaries in the long run. Along with the progress of the Financial System Reform, the role of SROs backed by the law is becoming increasingly important, and they are expected to intensify their efforts.

The SESC maintains a close interactive relationship with SROs and holds hearings with them on such matters as their surveillance.

The following are the activities of SROs from April 2001 to March 2002.

Note: The TSE and OSE changed from a membership organization to a stock corporation in 2001.

Section 2. Activities of the Japan Securities Dealers Association

1. Inspection of members

The JSDA inspected its regular members with emphases placed on compliance with laws and regulations from the standpoint of ensuring fair transactions by members, the

segregation of customers' assets from their own assets, compliance with suitability rules from the standpoint of further promoting proper investment solicitations by members, internal control systems from the standpoint of further promoting the improvement and strength of members' internal control systems, and the registration of sales representatives following the expansion of the scope of registration.

Note: Members are classified into two categories, according to their rights and duties, as follows:

Regular members: domestic and foreign securities companies

Special members: registered financial institutions

The JSDA inspected its special members, emphasizing compliance with rules and regulations concerning the securities business from the standpoint of ensuring fair transactions in securities businesses, such as the registration of special members, compliance with suitability in the retail business from the standpoint of further promoting proper investment solicitations by special members, and internal control systems from the standpoint of strengthening and completing their customer management systems.

In fiscal year 2001, the JSDA inspected 103 companies (domestic companies 89, foreign companies 14) were inspected.

The inspection of special members is conducted primarily by six associations organized by special members, such as the Japanese Bankers Association, under the delegation of operation by the JSDA. These associations implement inspections, working with personnel designated by the JSDA.

In fiscal year 2001, there were 70 financial institutions (45 banks, 13 *shinkin* banks, 10 insurance companies, 1 short-term money house, and 1 security finance corporation).

2. Surveillance of the securities market

The JSDA's OTC Stock Surveillance Division, which is responsible for market surveillance, collects market information related to registered OTC stocks and monitors stock prices and the trading volume of certain stocks as well as the involvement of members in transactions of those stocks. The division conducts investigations into certain stocks when it observes

irregularities in the transactions of those stocks. In addition, when the Securities Business Division reports violations of laws or the occurrence of incidents related to OTC-registered companies and having a considerable influence on investors' judgments, the Surveillance Division also conducts investigations and, when deemed necessary, further detailed surveillance.

The Surveillance Division maintains close relationships with relevant divisions when conducting market surveillance and, if necessary, requests audits by the Audit Division.

When inappropriate securities transactions are uncovered through surveillance, the JSDA takes appropriate measures in accordance with its Articles of Association against the members involved to prevent such transactions from recurring. In addition, when inappropriate securities transactions are suspected but cannot be proven, the JSDA cautions the members involved.

3. Disciplinary action

In fiscal year 2001, there were 15 cases of disciplinary action (¥392 million)

Section 3. Activities of stock exchanges

1. Inspections of members and special participants

Inspections of stock exchange members are conducted on their compliance with laws and rules laid down by stock exchanges. In the TSE, trading participants are mainly inspected with regard to inspecting trading participants effectively and profoundly for their compliance with regulations and TSE rules, especially regarding their activities from consignment to settlement, and strong measures are taken when violations are uncovered, understanding the cause of rule violations and the problems in internal management accurately and directing appropriate internal management, and cooperation with other SROs to make its inspections more efficient.

In fiscal year 2001, the TSE inspected 50 trading participants (41 domestic securities companies, 9 foreign securities companies) and sent deficiency letters to 23 companies. The OSE inspected 11 trading participants (11 domestic securities companies) and sent deficiency letters to 5 companies.

2. Market surveillance

Taking the TSE as an example, the Department of Market Surveillance and Compliance conducts investigations and surveys of stocks selected by examining collected market information, stocks notified by the Stock Market Department and Bond Market Department as unusual in their trading, and stocks about which the Office of Listings Supervision reported the occurrence of information that could influence investment decisions. Thus, the Department of Market Surveillance and Compliance conducts market surveillance in close cooperation with these departments.

When inappropriate transactions are uncovered through market surveillance, stock exchanges impose sanctions or take other actions against the members or special participants involved in order to prevent recurrence.

In addition, when securities transactions are suspected of being inappropriate but cannot be proven, stock exchanges caution the members involved to be prudent in transactions in the future in order to prevent unfair transactions from occurring.

In fiscal year 2001, the OSE uncovered a case of illegal short selling and imposed a sanction on the securities company involved in the misconduct.

3. Disciplinary action

The TSE had 18 cases of disciplinary action (¥190 million) and 11 cases of restricted trading. the OSE had 3 cases of disciplinary action (¥131 million).

Section 4. Activities of the FFA

The FFA inspected the activities of its members with respect to the management of financial futures transaction orders, the management of customers' margin deposits, and compliance with rules regulating financial futures transactions.

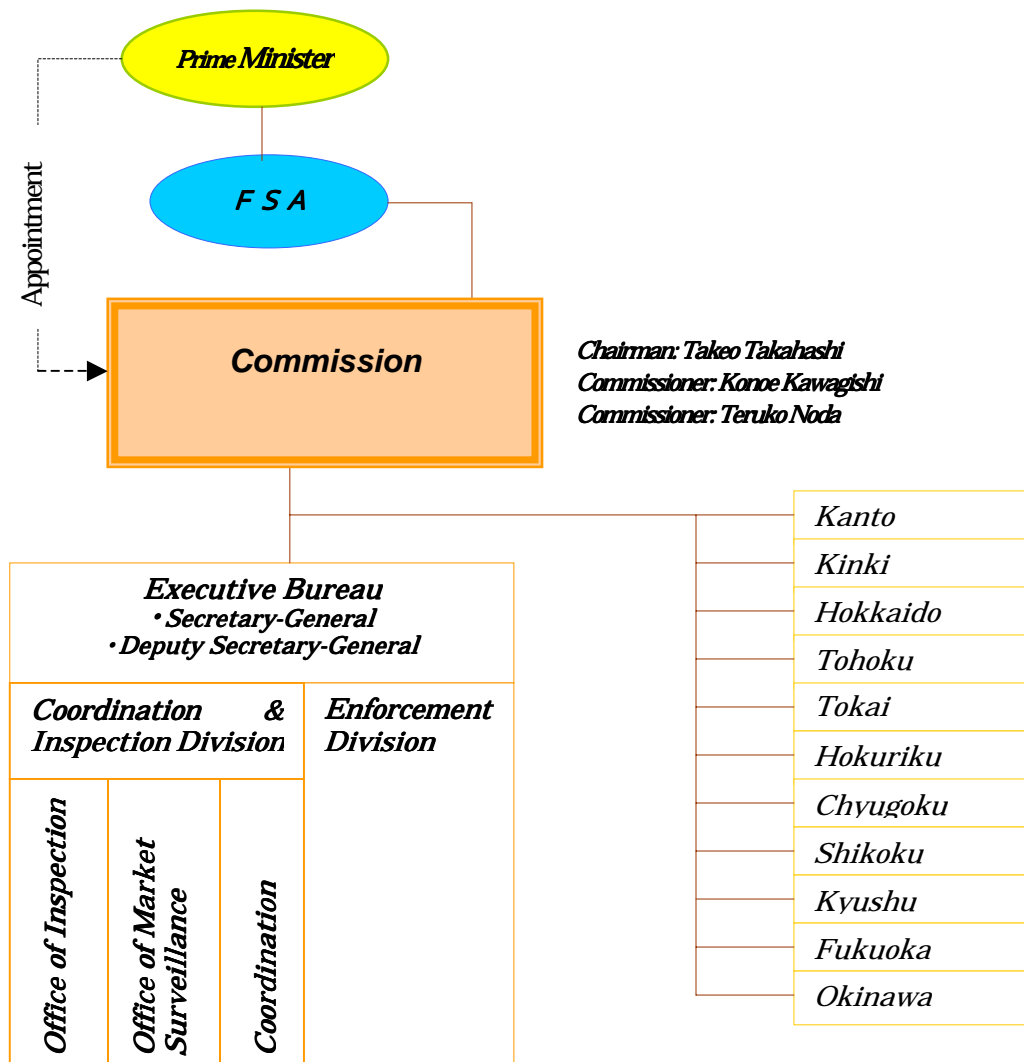
Section 5. Activities of the TIFE

The TIFE inspected the activities of its members with regard to compliance with rules

related to the management of the acceptance of financial futures transaction orders, the management of international control systems, and prohibited acts concerning financial futures transactions.

Diagram 1

Securities and Exchange Surveillance Commission Organization Chart



Note: Regional offices were established under the Regional Finance Bureaus of the Ministry of Finance to carry out SESC surveillance activities. The directors general of Regional Finance Bureaus conduct inspections and market surveillance under the authority delegated by the SESC and investigations of criminal offenses under the direct supervision of the SESC (see Diagram 3).

Diagram 2

Surveillance Framework

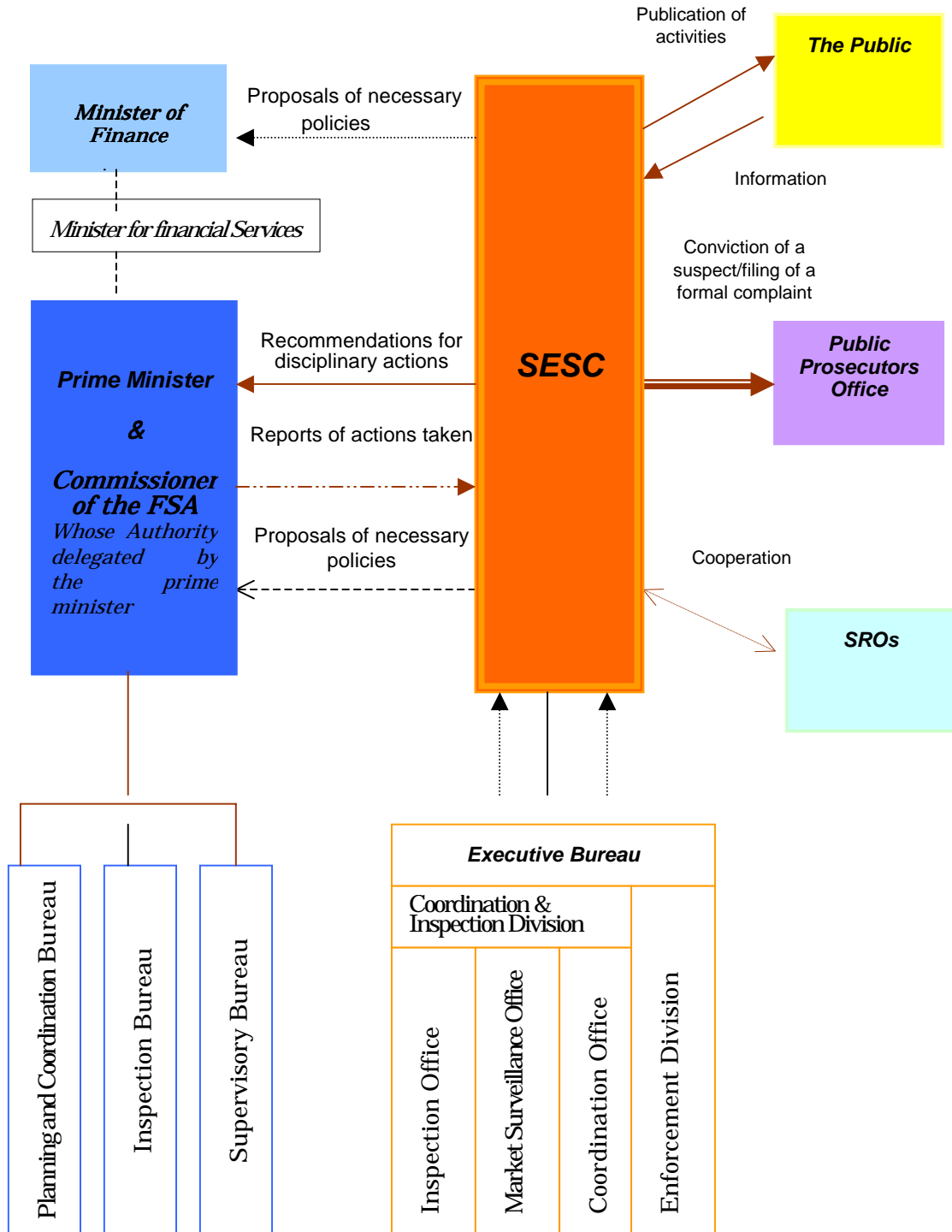
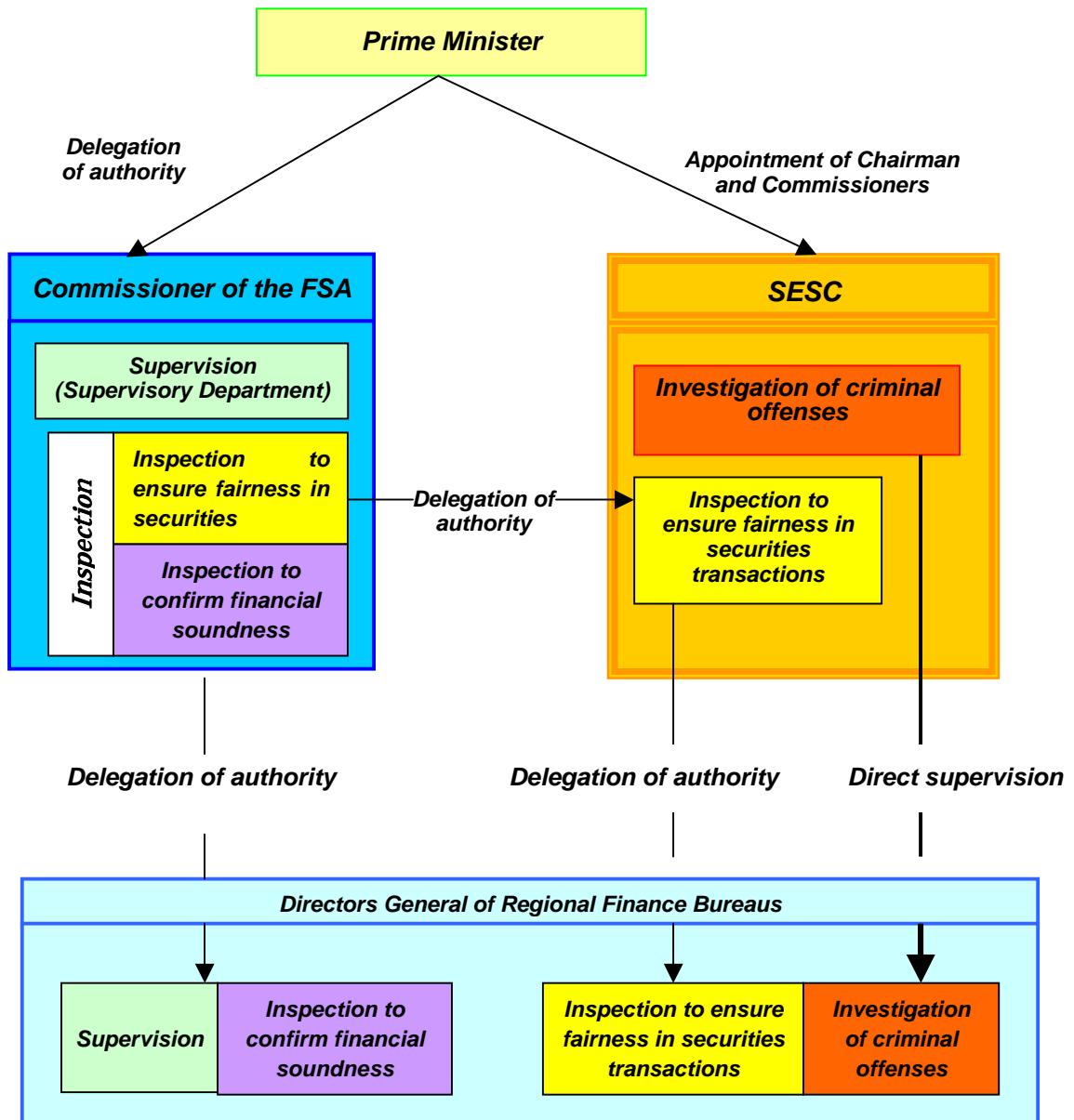
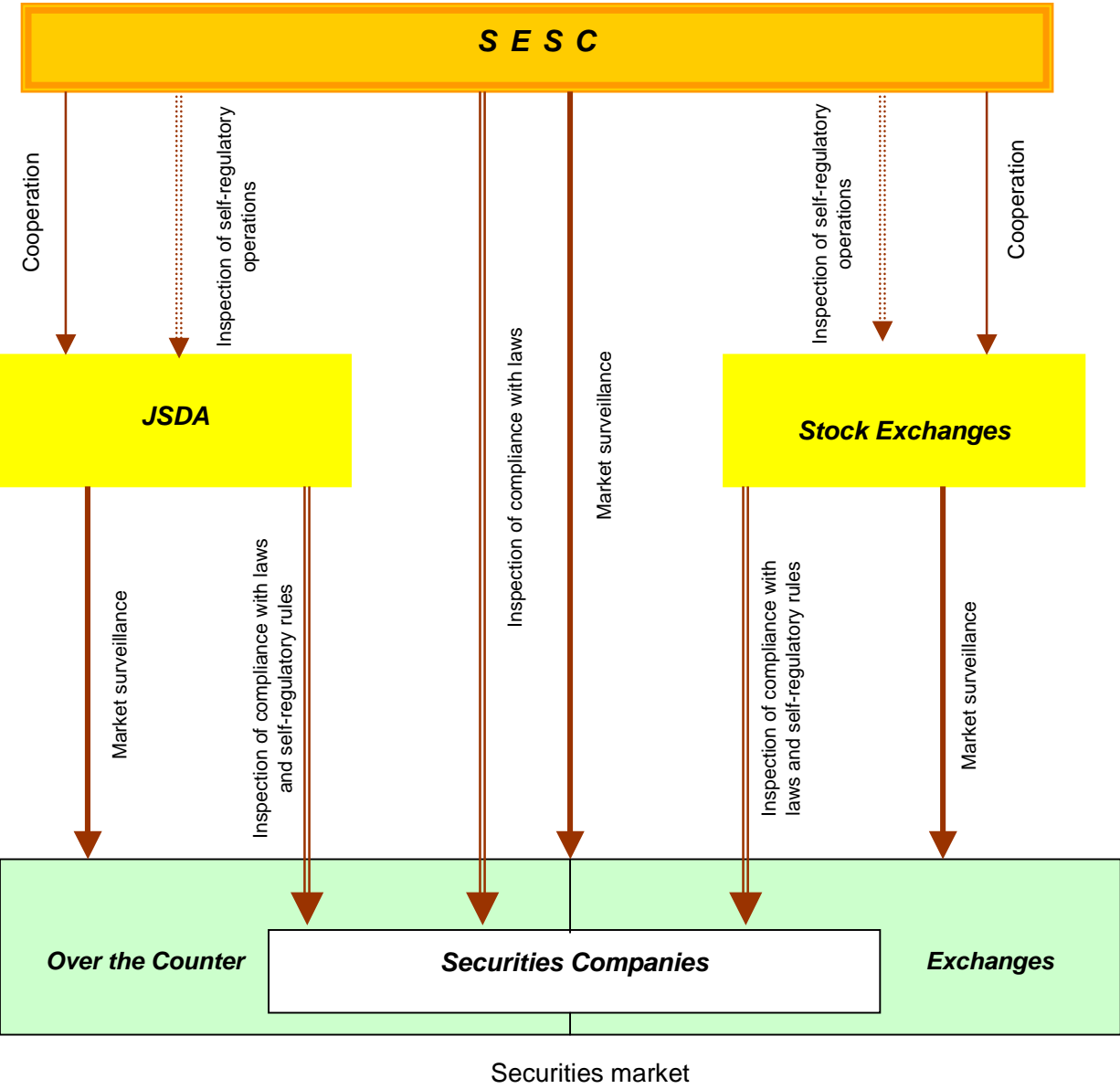


Diagram 3

Relationship among the Prime Minister, the Commissioner of the FSA ,the SESC, and Directors General of Regional Finance Bureaus



Note: Investigation of criminal offenses is carried out by the SESC staff under their peculiar authority prescribed in the SEL and other related laws. In contrast, inspection of securities companies is conducted under the authority delegated to the SESC by the prime minister and the commissioner of the FSA.



Note: The same system applies to financial futures.

Chairman and Commissioners Profiles



Chairman
Takeo TAKAHASHI

Before his appointment as commissioner of the SESC(1998), Mr.Takahashi served as chief prosecutor of the Tokyo District Public Prosecutors Office(1995-1997)and superintending public prosecutor of the Fukuoka High Public Prosecutors Office(1997-1998).in July 2001, he was appointed chairman of the SESC



Commissioner
Konoe KAWAGISHI

Mr.kawagishi was appointed commissioner of the SESC in july 1998.Before being appointed to the commission, he served as deputy chief of the Editorial Board of the yomiuri shimbun(a japanese newspaper company).



Commissioner
Teruko NODA

Ms.Noda was appointed commissioner of the SESC in July 2001.Before being appointed to the commission,she served as a partner of Chuo Audit Corporation(now Chuo-Aoyama Audit Corporation).

List of Abbreviations

EB	Exchangeable bond
FFA	Financial Futures Association of Japan
FFTL	Financial Futures Trading Law
FSA	Financial Services Agency
FSAEL	Financial Services Agency Establishment Law
IDC	Internet Data Center
IOSCO	International Organization of Securities Commissions
IPS	Internet Patrol System
JSDA	Japan Securities Dealers Association
LFSF	Law on Foreign Securities Firms
MOU	Memorandum of Understanding
OSE	Osaka Securities Exchange, Inc.
PTS	Proprietary Trading System
SCAN-System	Securities Comprehensive Analyzing System
SEL	Securities and Exchange Law
SESC	Securities and Exchange Surveillance Commission
SRO	Self-Regulatory Organization
STAF	Surveillance by Technical Analysis of Corporation Finance
TIFFE	Tokyo International Financial Futures Exchange
TSE	Tokyo Stock Exchange, Inc.