

**Chapter 1. Summary of SESC's activities****1. Overview of activities in Fiscal Year 2016**

Various changes took place in FY2016 (ending March 2017) in the domestic and global economic environment, affecting Japan's financial markets. Negative interest rates remained in place domestically, while interest rates stayed low globally as well as the result of monetary easing by central banks around the world. Looking at the global economy, the decision by the United Kingdom to leave the European Union, known as Brexit, and China's debt issue, among others, increased uncertainty of future prospects. Meanwhile, listed companies in Japan have been actively expanding their business as evidenced by the increasing number of M&A deals both in Japan and abroad.

Against such a backdrop, the Securities and Exchange Surveillance Commission (SESC) conducted market monitoring with a forward-looking perspective, focusing on risk factors and changes in the environment in Japan and abroad through analysis under a macro-economic approach. In performing its monitoring and investigation duties, the SESC not only made recommendations for administrative monetary penalties against violations of laws and regulations but also looked closely into the root causes to prevent recurrences.

**2. Increase in recommendations for administrative monetary penalties and filing criminal charges against market misconduct****(1) Recommendation for administrative monetary penalties and filing criminal charges against market misconduct**

There were 58 cases in which the SESC filed criminal charges or made recommendations for administrative monetary penalty payment orders. In particular, the number of recommendations increased significantly to 51 cases in FY2016 from 35 in the previous year.

**(2) Market surveillance leading to recommendations and criminal charges**

The number of market oversight examinations by the SESC and the local finance bureaus to identify signs of suspicious market misconduct or other potential infringement actions also increased to 1,142 in FY2016 compared to 1,097 in the previous year.

**(3) Trends in market misconduct**

Insider trading cases have increased both in relation to market surveillance and recommendations for administrative monetary penalties. In particular, amid moves to strengthen corporate governance and increased focus on return on equity, there was an increase in the number of insider-trading cases that involved such material facts as business alliances and takeover bids. There were also cases in which the material facts involved information on occurrences of data falsification. The investigation of insider trading highlighted various internal controls issues at listed companies, such as insufficient knowledge and inadequate handling of material facts.

Methods for market manipulation have become more complicated and cunning. With advancement of information technology, there were cases which induced algorithmic trading orders from other investors or placed orders using accounts at multiple brokerage houses to avoid detection of market misconduct. Some cases involved cross-border transactions by traders located overseas.

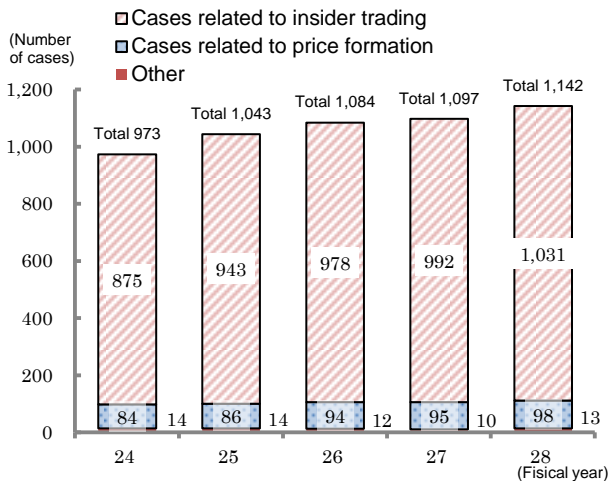
The SESC, going beyond just making a recommendation for administrative monetary penalties, filed criminal charges against a securities brokerage house suspected of using fraudulent means in selling Medical Accounts Receivable Securitized bonds (MARS), considering that the company's conduct was very malicious and exceeded the scope of issues to be addressed by administrative disciplinary actions.

**(4) Policy going forward**

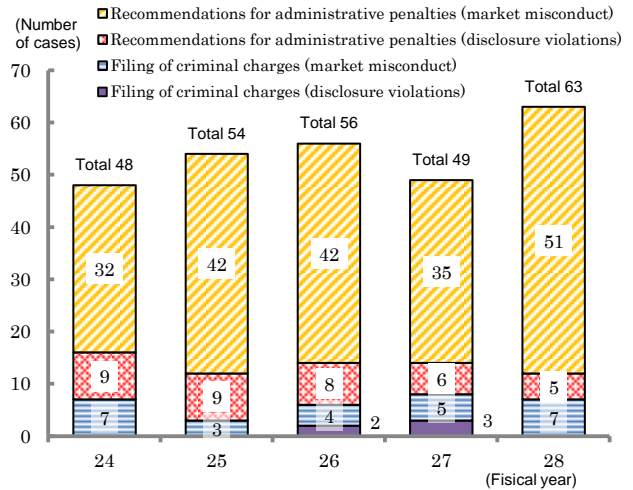
Going forward the SESC will continue to improve its market-monitoring systems and review

the method of investigation and inspection in order to keep pace with the changing environment surrounding the market and ensure flexible implementation of investigation and inspection.

### Results of Market Oversight



### Results of Enforcement Action



## 3. Disclosure violations highlight the risk to corporate governance

### (1) Recommendation on disclosure violations

There were still cases of companies in financial difficulties violating disclosure rules, with the SESC making recommendations regarding five such cases in FY2016.

### (2) Trends in disclosure violations

The cases in which the SESC found disclosure-related problems had such root causes as governance malfunction and inadequate awareness of compliance at the companies, and lack of intra-company communication.

Even among cases where there was no clear indication of disclosure violations, there were many in which listed companies were implicated in issues such as data or account falsification and forced to set up a third-party committee to investigate the matter, raising concerns of potential risk in internal controls.

### (3) Policy going forward

In order to address these risk factors, the SESC will carefully examine not only financial information on disclosure statements but also nonfinancial information, such as information related to corporate governance, and aim to deepen its analysis.

The SESC also aims to focus its efforts on finding and pointing out fundamental causes and conduct continuous monitoring in a forward-looking manner with the ultimate goal of preventing occurrences and recurrences of violations.

## 4. Shift from inspections to seamless on-site/off-site monitoring of Financial Instruments Business Operators, etc. (FIBOs)<sup>1</sup>

### (1) Recommendations for administrative disciplinary actions and announcement

The number of recommendations issued against FIBOs (excluding QII Business Operators)

<sup>1</sup> FIBOs are any businesses that are subject to securities monitoring, including financial instruments business operators, registered financial institutions, financial instruments intermediary service providers, qualified institutional investor business operators (QII Business Operators), credit rating agencies, and so on.

increased to 22 instances in FY2016 from 18 in the previous year.

An amendment to the Financial Instruments and Exchange Act (FIEA) that took effect in March 2016 enabled the Prime Minister to take administrative disciplinary actions against QII Business Operators, and the SESC made 13 recommendations against these operators in FY2016.

		(Fiscal Year)	'14	'15	'16
FIBOs (excluding QII Business Operators)	Number of recommendations		16	18	22
QII Business Operators, etc. (including Specially Permitted Investment Management Business Operators)	Number of recommendations		-	0	13
	Number of announcements		17	17	23

- The “number of recommendations” is of cases in which the SESC recommended that the Prime Minister and the FSA Commissioner take administrative disciplinary actions in response to violations of laws and regulations detected during on-site monitoring.
- The “number of announcements” is of cases in which the SESC made the on-site monitoring results public in response to violations of laws and regulations or problems concerning investor protection.
- The Specially Permitted Investment Management Business Operators (SPIMBOs) are those who operate businesses specified under the Article 48(1) of the Supplementary Provisions of the Act to Partially Amend the Securities and Exchange Act (Act No. 65 of 2006).

## (2) Principle approach to monitoring

The SESC had historically focused mainly on reviewing an entity's control environment for legal/regulatory compliance and financial soundness, and it had typically conducted these reviews through on-site inspections. However, since July 2016, the SESC has been conducting seamless on-site/off-site monitoring and effective risk assessments for all FIBOs, taking account of their business types, scale and other characteristics. In addition to monitoring each FIBO, the SESC has also reviewed the effectiveness of governance and internal audits, etc. at major FIBOs across business sectors.

FIBOs subject to on-site monitoring were determined based on risks identified through off-site monitoring. In carrying out on-site monitoring of a FIBO, the SESC conducted in-depth analyses of the entity's products and transaction schemes to assess the appropriateness of its business operations. When these analyses identified a problem, the SESC went further to identify the root causes of the problem.

## (3) Trends found in monitoring

The monitoring activities as described above shed light on many cases in which false representations or misleading representations were made about important matters (“misrepresentations”) in solicitation for the sale of privately-placed bonds and interests in funds or the conclusion of investment advisory contracts. In addition to misrepresentations in solicitation documents, there were a number of cases in which a violator used a website that showed FIBOs in a ranking format so as to mislead investors by making itself appear as a high-quality FIBO to investors.

In recommendation cases, the management of many of the FIBOs lacked awareness of their obligation to comply with laws and regulations and protect investors.

## (4) Policy going forward

The number of operators subject to monitoring by the SESC has increased to approximately 7,000 and these firms offer an increasingly diverse and complex set of services, products, and trading strategies. Amid such circumstances, the SESC aims to conduct more effective and efficient on-site monitoring based on risks identified through off-site monitoring, and strive to improve its system for conducting appropriate monitoring, especially in response to the introduction of regulations on operators engaging in high-frequency trading (HFT).<sup>2</sup>

<sup>2</sup> This refers to operators who perform HFT and are registered by the Prime Minister. Here, HFT refers to trades using computer programs which automatically make judgment on securities transactions and methods to shorten the time to transmit information.

## 5. New challenges for SESC: Efforts to enhance RegTech

### (1) Research into status of financial technologies and authorities' use of recent technologies in Japan and abroad

Advancements in IT and the convergence of finance and IT (FinTech) in recent years have brought dramatic changes to the face of transactions subject to the SESC's monitoring, and the situation has raised the possibility that new risk factors may emerge. Alarmed by this situation, the SESC has set a "more active use of IT in the market monitoring system (RegTech)" as one of its focus policy areas and conducted research into trends in financial technologies in Japan and abroad and the status of introduction of IT by regulatory authorities at home and abroad.

### (2) Issues under consideration

The results of this research have led to a realization that there is a risk that it may become difficult for the SESC to collect data from the subjects of investigation/monitoring due to the growing use of the block chain- and cloud computing technologies. The SESC also sees the risk that monitoring of transactions may become difficult as the amount of data for analysis may grow to excessive levels as HFT and algorithmic trading are used more widely. In recognition of such risks, the SESC aims to explore ways to take advantage of advanced technology to continue conducting effective market monitoring.

The SESC aims to closely watch new IT developments such as the growing use of virtual currencies, considering that they may have an impact on the market in various ways.

## 6. Cooperation with relevant authorities, accountability

### (1) Cooperation with relevant authorities

The SESC is working with self-regulatory organizations (SROs), such as financial instruments exchanges, on a daily basis in surveillance of trades, checks on the appropriateness of operations by member firms of such organizations, etc. It also exchanged opinions with such organizations on a regular basis and shared information on concerns, including those regarding risk factors that can arise amid changing macroeconomic trends, to further strengthen cooperation with them. In FY2016, the SESC met with SROs 12 times to exchange opinions. It also exchanged opinions with FIBOs, certified public accountants and certified administrative procedures legal specialists.

In terms of communication with overseas regulators, the SESC participates in a variety of discussions at the International Organization of Securities Commissions (IOSCO) as well as actively exchange opinions with other overseas regulators. In FY2016, the SESC made a total of 31 requests to overseas regulators in relation to investigations into market misconduct using cross-border transactions based on the Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information of IOSCO.

### (2) Effective dissemination of information

The SESC strives to enhance effective dissemination of information about SESC's activities and messages by providing the background and significance of each case and by making explanations concrete and easy to understand. In additions to publishing individual cases of recommendations for administrative actions, it uses channels such as press conferences, its website, lectures and casebooks on monetary penalties and FIBO monitoring results. In FY2016, the SESC held a total of 70 lectures for market participants, certified public accountants, attorneys, etc.