

## **Guideline for Supervision of Financial Instruments Firms, etc. for Program Year 2007**

### **I. Basic Approach**

#### **1. Understanding of Current Situation**

In the Japanese financial sector, which is currently biased towards indirect financing, the crucial issue is to shift the trend towards direct financing and indirect market financing, in other words to accelerate the shift of funds *from savings to investments*, in addition to stimulating Japanese financial and capital markets whose international presence is diminishing, and realizing the enhancement of their international competitiveness. It is necessary to further promote existing efforts to reform the Japanese financial and capital markets and expand their scope, thereby establishing attractive markets for market participants both at home and abroad. Self-help efforts made by financial institutions are becoming more important than ever before, as improvements have been made to a certain extent on the enforcement front while certain progress has been made in the development of frameworks in each of the three fields of financial regulation and supervision, namely the stability of the financial system, customer protection, and the establishment of fair and transparent markets. Against this backdrop, one of the major issues in financial regulation and supervision is making qualitative improvements in financial regulation (i.e., better regulation).

Bearing in mind that the Financial Instruments and Exchange Law will come into force at the end of September 2007, it is important to smoothly and properly implement the provisions of said law—which aims to develop cross-sectional and comprehensive customer protection rules and promote financial innovation—in an improved regulatory environment. For this purpose, the Financial Services Agency (FSA) shall take intensive and appropriate supervisory action in key areas in accordance with the basic approach described below.

The FSA shall continue to supervise securities companies, etc. based on the Guideline for Supervision of Securities Companies, etc. for Program Year 2006 until the Financial Instruments and Exchange Law comes into force.

#### **2. Realization of Qualitative Improvements in Regulation (Better Regulation)**

In the supervision of financial instruments firms, etc. efforts need to be made in terms of the supervision method with respect to the following four matters in order to make qualitative improvements in regulation (better regulation). Accordingly, the FSA shall strive to (1) enhance dialogue with financial instruments firms, etc., (2) enhance dissemination of information from the FSA, (3) enhance cooperation with foreign authorities, (4) accurately identify market trends through the enhancement of market research functions, and (5) improve the quality of FSA staff.

##### **(1) Optimal Combination of Rules-Based and Principles-Based Supervisory Approaches**

Based on the view that rules-based and principles-based supervisory approaches are mutually complementary rather than mutually exclusive, the FSA shall identify the respective fields in which these supervisory approaches

are effective (such as the rules-based approach being effective in cases where administrative dispositions are imposed under regulatory authority, and the principles-based approach in cases where financial instruments firms, etc. are encouraged to develop systems and in cases where new financial instruments and trading methods emerge one after the other) and boost the effectiveness of the regulations in their entirety, based on the optimal combination of these two approaches. In doing so, the FSA shall clearly define its policies, etc. for the application of laws and regulations in supervision guidelines, etc. as necessary, and endeavor to share its approach that underpin the rules as well as its understanding of principles through such means as engaging in dialogues with financial instruments firms, etc.

## **(2) Responding to High-Priority Issues Through the Effective Use of Regulatory Resources**

In order to effectively use limited regulatory resources and realize an improved regulatory environment, it is important to determine high-priority agendas and then invest resources into them on a preferential basis. By accurately identifying and analyzing information on the management status of financial instruments firms, etc. and market trends through continuous monitoring, dialogue, etc., the FSA will determine, as quickly as possible, fields in which risks at the business operation level are deemed to have a high possibility of materializing in the future and allocate its supervision resources to such fields.

## **(3) Placing Greater Emphasis on Incentives for Financial Instruments Firms, etc. and Encouraging Self-Help Efforts**

Considering that governance of financial instruments firms, etc. should be executed voluntarily by the management, the FSA will give due consideration to respecting such voluntary efforts, and to the greatest extent possible, take supervisory action focusing on encouraging the financial instruments firms, etc. to implement business improvement efforts proactively on their own.

## **(4) Enhancing the Transparency of Regulatory Actions**

In order to further improve the transparency and predictability of regulatory actions, the FSA will continue to publish various guidelines, policies, etc. and strive to sufficient communication through dialogue with financial instruments firms, etc.

## **II. Key Areas**

### **1. Key Areas in Supervision of Financial Instruments Firms**

#### **(1) Ensuring Appropriate Business Operation System and Staffing**

##### **1) Smooth and strict performance of registration tasks**

It is necessary to perform the task of registering financial instruments firms both promptly and smoothly so that it does not break the continuity of operations concurrently performed by an applicant currently engaged in a financial instruments business. At the same time, it is necessary that such registration tasks are performed strictly at the Local Financial Bureau, etc. that primarily undertakes such tasks for the purpose of eliminating incompetent financial instruments firms that are problematic in view of customer protection. It is important

that proper action is taken at the Local Financial Bureau, etc. while heeding the following four matters with respect to registration applicants, and the FSA shall provide necessary cooperation in this regard.

- In the case of continuing a securities business or other such regulated business that has been in operation since prior to the enforcement of the Financial Instruments and Exchange Law, have there been any material changes circumstances such as the securing of personnel required to execute such business?
- In the case of expanding business into other regulated industries or starting a new business subject to regulation after registration, have the personnel, etc. required to execute such business been secured?
- In light of the new provisions set forth in Cabinet Office regulations and supervision guidelines, is the registration applicant deemed incapable of properly executing a financial instruments business in terms of staffing?
- Have financial instruments firms who have no plans of joining the Financial Instruments Firms Association or becoming members or trading participants of a financial instruments exchange formulated appropriate internal rules in consideration of the regulations of associations, etc.?

## **2) Development of system for financial instruments firms, etc.**

Financial instruments firms should consistently endeavor to secure a proper business operation system and staffing for the execution of a financial instruments business of their own accord based on the principle of self responsibility. Accordingly, it is important that each financial instruments firms strives to develop proper governance and a system to ensure procedures to select directors and employees, etc. in accordance with the principles set forth in the Cabinet Office regulations and supervisory guidelines even after the dealer is registered with the Local Financial Bureau, etc.

## **(2) Development of an Advanced and Robust Compliance System and Risk Management System**

In order for financial instruments firms to operate their businesses in a sound and appropriate manner based on a high standard of self-discipline, it is necessary that the management first raises its awareness of compliance and becomes actively involved in compliance. Having done this, it is important that the compliance department and the risk management department properly fulfill their respective functions.

### **1) Verification of compliance system**

The FSA shall continue to intensively verify the state of efforts made in raising the management's awareness of compliance and efforts made to develop and implement a compliance system by such means as conducting comprehensive hearings. The FSA shall also verify the appropriateness and effectiveness of financial instruments firms' compliance systems by such means as following up on improvements to the situation after administrative action has been taken.

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

It is important that not only market and credit risk but also information system and operational risk (risk of the company incurring a loss due to an accident, fraud, etc. caused by a director or an employee) are properly managed as required by laws and regulations. Furthermore, it is believed that the importance of properly managing legal risk and rumor risk is growing in conjunction with the increase in potential conflict of interest due to increased diversification and complexity of operations of financial instruments firms. Based on this view, the FSA shall verify financial instruments firms' risk management systems by such means as conducting comprehensive hearings.

### **3) Verification of internal audit department**

For the management to strictly enforce compliance with laws and regulations, etc. within the company or to properly manage risks, the role to be fulfilled by the internal audit department—namely to develop a compliance system and risk management system and verify whether these systems are properly functioning within the company—is deemed to be significant. The importance of such department is expected to increase, due in particular to the risk of management oversight becoming insufficient as operations become larger in scale or more complex. Based on this view, upon verifying the compliance system and the risk management system, the FSA shall examine whether the internal audit system is effective—particularly in regards to the effectiveness of the compliance system and the risk management system is properly verified by the department—by such means as conducting hearings on the implementation status of internal audits based on internal audit plans, internal audit reports, etc.

### **(3) Customer Protection**

#### **1) Ensuring proper solicitation and explanation**

The Financial Instruments and Exchange Law categorizes investors as professional investors and ordinary investors, partly in view of maintaining the balance between protecting customers properly and facilitating the supply of risk capital. It stipulates that in cases where a financial instruments dealer performs a transaction with an ordinary investor, a sufficient code of practice shall be applied in view of customer protection, whereas in cases where the dealer performs a transaction with professional investors, many provisions of the code of practice may be exempted from application.

Based on such stipulations, the FSA shall continue to verify the following matters according to the products and services actually handled by financial instruments firms by such means as conducting hearings, and take strict supervisory action if problems are deemed to exist.

- After properly screening investors to distinguish between professional and ordinary investors, have the customers' attributes and understanding and the objective of the transactions, etc. been properly identified, and has solicitation been carried out and explanations provided properly in light of such information and the properties of the financial instruments in question?
- Is the information on risks, fees, etc. clearly presented in an easy-to-understand format in the marketing materials (advertisement, etc.) used upon solicitation?

#### **2) Development of system for financial instruments firms, etc.**

It is important that financial instruments firms develop the following in-house systems for the purpose of carrying out solicitation and properly providing explanations as described above, and protecting customers in an appropriate manner.

- A system for screening investors to separate them into professional investors and ordinary investors and an in-house system to verify its appropriateness afterwards
- A customer management system, in-house training, etc. to observe the suitability rule
- Screening system for advertisement, etc.
- A system to deal with queries and complaints from customers in a sincere and appropriate manner from the standpoint of the customers

Moreover, as financial instruments are becoming increasingly sophisticated and complex and new products are

being released one after another, it is impossible to establish detailed customer protection rules in advance for all financial instruments, and as such it is important for each company to develop an appropriate system and make voluntary efforts to protect customers based on the principles set forth by laws and regulations. The FSA shall verify the development status of systems while respecting such voluntary efforts.

#### **(4) Customer Information Management**

##### **1) Ensuring customer information management**

In principle, multiple businesses can be operated based on a single registration after the Financial Instruments and Exchange Law comes into force, and as such the operations of financial instruments firms are expected to become more diversified. Under these circumstances, the FSA shall keep an eye on whether or not any personal information or customer information including corporate information has been leaked, lost or impaired, and in particular whether such information is being shared improperly between groups, and, as necessary, take supervisory action pursuant to the Financial Instruments and Exchange Law, the Personal Information Protection Law, etc.

##### **2) Development of system for financial instruments firms, etc.**

The proper management of customer information is an important issue not only from the viewpoint of protecting personal information but also from the viewpoint of preventing conflicts of interest between groups, preventing insider trading, etc. The FSA will verify whether appropriate systems for managing customer information have been established by financial instruments firms from these viewpoints.

#### **(5) Governance of Financial Conglomerates**

As financial conglomeration is gaining momentum and operations of financial instruments firms are diversifying, it is becoming increasingly important for groups consisting of financial instruments firms to make efforts to settle potential conflict of interest and concentration, uneven distribution and dispersion of risks, and to ensure the appropriateness of intra-group transactions.

Accordingly, the FSA shall verify financial conglomerates consisting of financial instruments firms with respect to the governance systems, etc. of groups in accordance with the Guideline for Financial Conglomerates Supervision, etc.

## **2. Key Areas in Supervision by Business Type**

### **(1) Matters requiring Special Attention for Entities Engaged in the First Financial Instruments Business**

Entities engaged in the first financial instruments business are required to establish governance, compliance and risk management systems that are equivalent to or more robust than those conventionally required among securities companies in accordance with the new regulations and the diversification of operations.

Accordingly, the FSA shall pay special attention to the following matters, verify the inspection results, monitoring surveys and clues from queries and complaints, and take necessary supervisory action.

#### **1) Ensuring appropriateness of operations**

- Do securities companies advertise securities-related businesses appropriately in light of the new advertising regulations to be introduced?
- In over-the-counter financial futures trading business, are unsolicited calls made or repealed solicitation

conducted? Is the risk of the loss exceeding the principal and other such matters explained properly to customers?

- Is the capital adequacy ratio calculated based on an accurate calculation method? Does it fall short of the level set forth by laws and regulations? If it fluctuates substantially, is an appropriate response contemplated? In groups of financial instruments firms operating internationally, is the group-based capital calculated and managed properly pursuant to the Guideline for Financial Conglomerates Supervision and the Notice for Bank Holding Companies?

## **2) Development of system for financial instruments firms, etc.**

- In the case of operation of securities-related businesses, is proper action being taken in consideration of the *Summary of Issues* published by the Round Table Conference on the Financial Market Intermediation Function of Securities Companies based on self-imposed rules, etc. formulated by the Japan Securities Dealers Association (JSDA), etc. for (1) improving the reliability of operations, (2) demonstrating the checking functions targeted at issuers, (3) demonstrating checking functions targeted at investors, and (4) maintaining self-discipline as market players?
- In cases where the group is engaged in investment banking, principal investment or other such businesses, is the group taking measures to properly manage potential conflict of interest between financial instruments firms and customers or between customers?

## **(2) Matters requiring Special Attention for Entities Engaged in the Second Financial Instruments Business**

Entities engaged in the sale/solicitation, public issue or private placement of rights to interests in so-called collective investment schemes (funds) are deemed to include entities that were not subject to supervision by the FSA prior to the enforcement of the Financial Instruments and Exchange Law, and entities that deal in funds with limited transparency and liquidity for which investors have extreme difficulty in identifying their actual state and valuing them.

With this in mind, in supervising financial instruments firms that deal in such rights, the FSA shall properly identify the outline of partnership agreements concerning such rights, the outline of business actually operated by such funds, and information on risks concerning the rights under such agreements, and shall pay attention to whether or not a sufficient explanation of these matters are provided to investors, etc. Furthermore, the FSA shall properly cooperate with relevant authorities and take necessary action in cases where the actual state of their business is deemed to correspond to multilevel marketing business under the Act on Specified Commercial Transactions or similar transactions.

## **(3) Matters requiring Special Attention for Entities engaged in Investment Management Business**

With respect to investment trust management business, institutional investors' asset management business, discretionary investment business, and investment management business of so-called collective investment schemes, the FSA shall continue to strictly verify whether there are any breaches of fiduciary duty with respect to customers or duty of care of a competent manager while heeding the following matters, and take necessary supervisory action.

- Has a proper business execution system been established for managing and investing investment assets and executing trades?

- Is inappropriate advertising, etc. being placed such as misleading representations using simulations based on arbitrary assumptions?
- With respect to real estate fund investment businesses, the FSA shall pay due consideration to such changes as the real estate market's growing correlation with the financial market (commodification of real estate into financial instruments) and with overseas markets (globalization) and the expanding supply of risk money, and perform necessary verification and take supervisory action with respect to due diligence systems upon the acquisition and sale of real estate and systems to prevent conflict-of-interest transactions, so that the pricing function is demonstrated appropriately. Meanwhile, it is necessary to bear in mind that such supervision is not intended to affect individual real estate prices.

#### **(4) Matters Requiring Special Attention for Entities Engaged in Investment Advisory and Agency Businesses**

The FSA shall heed and verify investment advisory and agency businesses as to whether or not they are placing misleading advertising, etc. such as making unsubstantiated representations that the track record of their advice, etc. is substantially superior, and in cases where agency or brokering business is undertaken under an investment advisory agreement or a discretionary investment management agreement from two or more affiliated companies, whether or not the necessary explanations, etc. have been provided from the viewpoint of customer protection, and shall take necessary supervisory action.

### **3. Matters Requiring Special Attention for Funds**

Businesses engaged in the public issue (private placement) or management, etc. of rights to so-called collective investment schemes (funds) are deemed to include a wide range of entities. For example, some of them may correspond to entities engaged in the aforementioned the second financial instruments business and investment management business, while others may be engaged in special operations such as those of eligible institutional investors by filing a notice (business concerning private placement or management of various partnership schemes in which investors consist of institutional investors plus no more than 49 general investors). Codes of practice and supervision authority are limited with respect to these entities.

On the one hand, funds are expected to help form markets "with depth", promote financial innovation and internationalize Japanese financial and capital markets by demonstrating their diversity in an appropriate manner. However, on the other hand, they are deemed to be exposed to specific potential risks.

Accordingly, the FSA shall take into account the discussions that have taken place at international conferences such as the finance ministers summit meeting and the G8 Summit in Heiligendamm in 2007, and for example, with respect to entities that deal in foreign funds that have no investors in Japan, it shall keep a close eye on overall trends and reviews and enhancements in industry practices and take such action as monitoring risk management by counterparties (financial instruments firm, etc. that happens to be the other party to the transaction). On the other hand, with respect to entities that deal in funds subject to supervision and mandatory registration or notification, the FSA shall carry out supervision properly after identifying their actual state sufficiently from the viewpoint of customer protection, etc. In such a manner, funds need to have the whereabouts of their risks identified as quickly as possible in accordance with various investment structures, and have supervisory resources allocated.

The supervision guidelines require that a monitoring survey be conducted on fund managers subject to supervision and mandatory registration or notification (entities engaged in investment management business or special operations such as those of eligible institutional investors (business involving investment on own account) with respect to three pieces of information, namely, (1) name of fund, (2) type of fund, and (3) total amount of invested assets. The FSA shall identify the overall trends through such surveys, use this as an opportunity to engage in dialogue with the entities concerned, consistently identify, investigate and analyze the actual state of the industry and take action preemptively by forecasting the future materialization of risks.

#### **4. Key Areas in the Supervision of Registered Financial Institutions**

##### **(1) Prevention of Abuse of Dominant Position**

After the Financial Instruments and Exchange Law comes into force, financial institutions are expected to deal in derivatives trading, etc. as a business of a registered financial institution, while engaging in such transactions as loans as a financial institution. Under such circumstances, the FSA shall carry out the necessary supervision in view of the Financial Instruments and Exchange Law with respect to the following matters, in consideration of the incident in which the Japan Fair Trade Commission (JFTC) issued an elimination recommendation to a bank in December 2005.

###### **1) Prevention of abuse of dominant position**

- Does the registered financial institution abuse its dominant position against its customers, such as insinuating that it will cancel its lending if the customer does not agree to sign a financial instruments contract or if the customer signs a financial instruments contract with a competitor who operates a business as a registered financial institution?

###### **2) Development of system for registered financial institutions, etc.**

- Has the financial institution developed necessary systems to prevent its dominant position from being abused, such as establishing responsible departments, conducting training programs, and properly dealing with complaints and queries?

##### **(2) Matters Requiring Attention in Sales of Investment Trusts, etc.**

In cases where a registered financial institution deals in risky financial instruments such as investment trusts, it is necessary to endeavor to prevent them from being misconstrued as deposits, etc. Accordingly, the FSA shall carry out necessary supervision with respect to registered financial institutions, as to whether they carry out solicitation and properly provide explanations pursuant to the Financial Instruments and Exchange Law, etc. Furthermore, the FSA shall supervise registered financial institutions by heeding whether they have a policy to deal with customers in a sincere and fair manner pursuant to laws and regulations, etc. in the event of any mishaps in transactions of financial instruments and in other such cases.

##### **(3) In-House Information Management System**

It is important that an appropriate in-house information management system be developed by registered financial institutions in order to prevent them from abusing their dominant positions and prevent conflict of interests, etc. In particular, the FSA shall verify information management between the department that handles credit derivatives transactions and the loans department, and the effectiveness, etc. of the prevention of conflict of interest.

## **5. Key Areas for Unregistered/Unlicensed Entities**

The Financial Instruments and Exchange Law seeks to thoroughly enforce customer protection by bringing a wide range of entities that have previously existed in the loopholes of business laws into the framework of regulations. Some of these entities are deemed as continually operating, either intentionally or negligently, without registering or filing a notice even after the Financial Instruments and Exchange Law comes into force.

If the existence of such entities is identified through complaints, queries, etc., the FSA shall warn such entities in writing, etc. to immediately suspend their activities in question, and in cases where they are operating due to negligence, the FSA shall make such entities first apply for registration or file a notice promptly under the Financial Instruments and Exchange Law. If they are operating intentionally or in other such cases, the FSA shall immediately contact the law enforcement authorities, etc. and take measures to prevent damage to customers from arising and spreading.

## **III. Supervision Method**

### **1. Ensuring Proper Cooperation with Inspection and Oversight Departments/Bureaus**

Based on the appropriate division of roles between the Supervisory Bureau and the Executive Bureau of the Securities and Exchange Surveillance Commission (SESC), etc., the FSA shall seek to cooperate properly by exchanging information obtained in the course of supervision that is applicable to inspections and information obtained in the course of inspection that is applicable to supervision, such as sharing mutual awareness of problems and information.

### **2. Cooperation with Self-regulatory Organizations, etc.**

As efforts are being made to formulate self-imposed rules, etc. by JSDA, etc. pursuant to the *Summary of Issues published by the Round Table Conference on the Financial Market Intermediation Function of Securities Companies*, the FSA shall continue to follow up on such efforts and seek appropriate cooperation with self-regulatory organizations in verifying the extent to which financial instruments firms, etc. are observing the self-imposed rules based on the *Summary of Issues*. In particular, in order to establish markets with a high level of fairness and transparency, it is important for securities companies and other such market players to establish a code of ethics, and as such the FSA shall cooperate in efforts made by self-regulatory organizations for this purpose.

Furthermore, upon the enforcement of the Financial Instruments and Exchange Law, it is important that the self-regulation functions enhanced by the above-mentioned law be demonstrated effectively in the course of making efforts to realize qualitative improvements in regulation, and that the principle of said law—which is to develop cross-sectional and comprehensive customer protection rules—will be fulfilled at the level of self-imposed regulations as well. Accordingly, the FSA shall properly follow up on the efforts made by each association in consideration of the *Interim Summary of Issues on the Status of Financial Instruments Firms Association* and provide necessary cooperation. In particular, the FSA shall properly cooperate in developing a system to resolve complaints in each self-regulatory organization or such a system that cuts across different

industries.

The FSA shall pursue proper cooperation to eliminate organized crime groups, etc. from financial instruments businesses by way of cooperating with related institutions through the Securities Safeguard Liaison Council.

As for certified investor protection organizations, the FSA shall establish criteria for their certification and other necessary matters, and take proper action so that the certification system truly functions effectively from the viewpoint of customer protection.

### **3. Relationship with Financial Instruments Firms, etc.**

It is important to promote mutual understanding between the FSA and entities subject to supervision, enhance the dissemination of information from the FSA and the identification of market trends, and improve the transparency and predictability of FSA's responses by actively engaging in dialogue with financial instruments firms, etc.

In particular, the enforcement of the Financial Instruments and Exchange Law will enable the FSA to issue orders such as to modify business methods to the extent necessary in cases where it is deemed necessary and appropriate in the interest of the public or for the purpose of protecting investors, even if financial instruments firms, etc. are not necessarily violating laws and regulations, etc.

The management of financial instruments firms, etc. is required to ensure appropriate internal control in consideration of the fundamental approach underpinning the laws and regulations and the principle and objective of the regulations. Accordingly, the FSA shall sufficiently exchange opinions with the management, etc. of financial instruments firms, etc. on such matters and verify the effectiveness of the management's internal control while respecting its voluntary efforts in implementing internal controls.

### **4. Enhancement of Cooperation with Foreign Supervisory Authorities, etc.**

As financial conglomerates and cross-border transactions of financial instruments are increasing, the FSA shall endeavor to further enhance cooperation with foreign supervisory authorities, etc. through the exchange of information and opinions, in order to properly supervise financial instruments firms, etc.

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