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Financial Services Agency

## **Annual Supervisory Policies for Financial Instruments Business Operators, etc. for Program Year 2010**

The Financial Services Agency (FSA) publishes its Annual Supervisory Policies for Financial Instruments Business Operators, etc. for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.,” which show basic approaches for the supervisory process aimed at financial instruments business operators, etc.

In this Program Year, in accordance with the “Basic Concept of Future Supervision” as shown below, the FSA will place priority on the three areas of 1) appropriate demonstration of market intermediary functions, 2) promotion of high quality risk management, and 3) improving customer protection and convenience for users, and will supervise financial instruments business operators, etc. while striving to have frank and deep discussions with them.

It should be noted that these supervisory policies were drawn up in light of the circumstances that surrounded financial institutions as of August 2010, and may be subject to review as necessary.

### **1. Environment Surrounding Financial and Capital Markets, and Basic Concepts on Supervision of Financial Institutions for the Future**

#### **(1) Environment Surrounding Financial and Capital Markets**

Japan’s economy is now solidly recovering, but still faces harsh conditions, with risk factors from global economic recession concerns, fluctuations in financial and capital markets, effects of deflation, etc.

In particular, large growth in fund inflows was seen in emerging economies, supported by their fast growth, while in Europe, fiscal problems sparked by Greece became more serious, and in the U.S., there was stronger sentiment that the economic outlook is unclear. In response, uncertainty in financial and capital markets has increased along with larger price fluctuations. Under these conditions, global movements are having even greater effects on Japan than before.

Also, in the “New Growth Strategy” approved by the Cabinet in June this year, the financial sector is expected to back up and support the real economy and enterprises by providing funds with a focus on future growth potential. The financial sector is also expected to lead the economy as a growth industry.

Under these conditions, it has become even more important that financial instruments business operators practice legal compliance thoroughly, and also properly demonstrate their market intermediary functions as market participants, thereby boosting investors’ trust in Japan’s markets and leading to market development. For financial instruments business operators to play this role, they must ensure sound finances by practicing risk management, etc.

## (2) Approach Taken by Financial Supervisor

Based on the above understanding, in the financial supervision for this Program Year, the basic policy is to further solidify and make progress in “Better Regulation” (engaging in frank and deep discussions with financial institutions, disseminating information to the outside, sharing and linking information on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of regulatory actions). In particular, in properly demonstrating their market intermediary functions, accurately managing various risks, customer protections, etc., financial institutions are strongly expected to be aware of long-term managerial issues. They are also expected to conduct positive managerial reforms, and make appropriate, quick, and responsible business judgments under the appropriate leadership of management personnel. To this end, the FSA will take the following approaches as the supervisory authority.

### 1) Supervisory Response based on High Risk Sensitivity

In order to accurately respond to currently conceivable risks, the FSA will gain a deeper understanding of the macroeconomy and market trends, deepen its awareness of how these affect the soundness of financial institutions, and identify and understand from a forward looking perspective the risks which accumulate in each financial institution and in the financial system. It will also promote integrated on-site and off-site monitoring in an effort toward early identification of risks.

### 2) Supervisory Response from a Citizen’s and User’s Point of View

The FSA will strive to take regulatory actions so as to further improve customer protection and convenience for users, by looking at things from a citizen’s and user’s point of view.

### 3) Supervisory Response with a Future Outlook

The FSA will strive to take regulatory actions, which are not only short-term responses, but also medium- and long-term responses with an eye on the future, by seizing the trend of international discussions in a sufficient manner and considering environmental changes.

### 4) Supervisory Response which Contributes to Autonomously Improving Management and Making Better Business Judgments of Financial Institutions

The FSA will help financial institutions autonomously improve management and make better business judgments, via frank and deep discussions and the distribution of information with financial institutions.

In performing supervision, in addition to these approaches, the FSA will also bear the following points in mind.

- In addition to encouraging closer cooperation with the Securities and Exchange Surveillance Commission (SESC) and other affiliated divisions as well as with self-regulatory organizations (SROs) and the Bank of Japan (BOJ), the FSA will also strive to cooperate with overseas authorities via supervisory colleges, and positively contribute to organizations which set international standards.

- The necessity of reports and submitted documents will be periodically reviewed once per year, as part of considerations for reducing the burdens on financial institutions.
- Through the thorough fostering, securing and training of specialized human resources, the FSA will redouble efforts for human resource development.

## 2. Appropriate Demonstration of Market Intermediation Functions

1) Financial instruments business operators etc. play a public role as market intermediaries when investors and fundraisers access the markets. There is a need for them to develop internal control systems in order to properly perform this market intermediary function. The FSA will examine each company's systems from this viewpoint.

Specifically, the FSA will conduct investigations while placing priority on (i) Improved reliability of operations such as order-receiving management to prevent mistaken orders, (ii) Demonstration of function of checking issuers in underwriting examinations, (iii) Demonstration of function of checking investors such as in customer management and trading examinations, (iv) Maintenance of self-discipline, including prevention of conflicts of interest between units which trade on the company's own account and other units, etc.

2) Among other things, customer information forms the basis of financial instruments transactions and the intermediation thereof, and so it also needs to be managed strictly from the viewpoint of protecting personal information. Furthermore, it is important to strictly manage corporate information in order to increase trust in the market, and market transparency and fairness. From these viewpoints, the FSA will examine whether management is making autonomous efforts for the maintenance of internal control systems for information security, and for the enhancement of rules of professional conduct to prevent inappropriate actions of officers (such as information leaks or insider trading).

3) In order to thoroughly eliminate anti-social forces such as organized crime from securities trading, this May, the National Police Agency decided on a policy to build a framework to enable quick provision of information on organized crime to the securities industry. Based on this, the FSA is encouraging each securities company to make stronger efforts to eliminate anti-social forces, including the building of an anti-social forces database by the Japan Securities Dealers Association.

## 3. Encouragement of High Quality Risk Management

In their financial results for the year ended March 31, 2010, securities companies saw slight improvements compared to the previous fiscal year, as the domestic economy solidly picked up, and with fund inflows into investment trusts and large underwriting projects. However, the earnings environment of financial instruments business operators was not necessarily good, with continuing low stock trading volumes, etc. Under these conditions, it is increasingly important for financial instruments business operators to thoroughly perform high quality risk management. The FSA will encourage autonomous efforts by each financial instruments business operator, especially regarding the following points.

### (1) Encourage Integrated Risk Management of the Entire Securities Company Group

- 1) To ensure the sound management of securities companies, the FSA will continue to accurately operate an early warning system, gain an overview of business models and recent business conditions, and perform cross-industry and time series analyses. In cases where there are concerns about business difficulties, the FSA will quickly understand the situation, paying special attention to liquidity risks resulting from bad financial performance.
- 2) Consolidated supervision and regulation of securities company groups will be introduced in April 2011. Based on this, the FSA will conduct investigations while prioritizing the timely and accurate understanding of the business status of entire groups, and the situation of preparation of entire groups' integrated risk management systems.

Especially for securities company groups which are internationally active and have large and complex operations, considering the great potential risks to the financial system and entire economy, the FSA will perform even more detailed monitoring of financial soundness and risk management from a forward looking viewpoint. To do this, the FSA will perform integrated on-site and off-site monitoring in close cooperation with inspection divisions.

#### (2) Response to Various Funds

- 1) For early response to forecasts of the future appearance of risks, the FSA is strengthening its efforts to understand the status of solicitation and operation in various funds, including hedge funds.
- 2) For listed J-REITs (real estate investment trusts), which hold an important position in the real estate market, the FSA will continue monitoring the status of operations including cash flow, and encourage them to provide information to investors in an appropriate manner.

### 4. Improving Customer Protection and Convenience for Users

#### (1) Response to Credit Rating Agency Regulation

- 1) With the introduction of public regulation of credit rating agencies, for rating agencies which have registered or filed registration applications, the FSA will examine the situation of systems developed to prevent conflicts of interest and to maintain a fair rating process, and the information disclosure situation of creating and publishing rating policies.
- 2) The FSA will also check whether proper systems are developed in securities companies to explain ratings produced by unregistered credit rating agencies. Furthermore, the FSA will encourage securities companies to quickly consider credit risk evaluation methods which do not rely on ratings, in order to enable the provision of information to investors even if ratings are not used.

#### (2) Solicitation and Presentation

The FSA will encourage financial instruments business operators, etc. to operate while keeping in mind the viewpoints of customers so that they can establish long-lasting relationships with their customers and gain customers' trust and confidence.

- 1) Regarding sales of risky products such as investment trusts, structured bonds and derivatives, the FSA will conduct investigations while placing priority on whether the system of solicitation and explanation considers each customer's standpoint. The FSA will place particular priority on its investigations of (i) Whether appropriate and flexible explanations are being provided which reflect the situation of the customer's knowledge, experience, assets, purpose of investment, etc. to enable the customer to accurately judge the locations and characteristics of risks; (ii) Whether checksheets are created and required where needed to confirm that the customer understood the explanation.
- 2) In particular, the FSA will conduct investigations while placing priority on (i) whether suitable explanations are being provided corresponding to each product characteristic and risk characteristic in sales of investment trusts, such as funds targeting stocks and bonds of emerging economies, currency selection type funds, and monthly distribution type funds, and (ii) in sales and cancellations of investment trusts, whether suitable explanations are being provided regarding important items which affect customer investment decisions, such as commissions, investment trust fees and other costs in sales and cancellations of investment trusts.”
- 3) The FSA will verify the legal compliance situation regarding uninvited solicitation regulations, considering the situation of laws and regulations developed. Based on the supervisory policy on derivative transaction sales, which was revised in April this year, the FSA will also encourage the Japan Securities Dealers Association to create appropriate self-regulation.

(3) Check the Systems to Deal with Customer Complaints and Consultation Requests

The FSA will check whether financial instruments business operators make themselves ready for the commencement of the financial ADR system, which will be introduced in October this year. For business operators which are not members of a Financial Instruments Firms Association, the FSA will conduct investigations while placing priority on whether they have in place appropriate systems to deal with complaints and requests for consultation from customers.

(4) Stronger Regulation of Foreign Exchange Margin Transactions

- 1) Regarding foreign exchange margin transactions, the FSA will check the status of FX traders' responses to the margin regulations implemented in August this year, and the stronger margin regulations planned for August next year. In addition, the FSA will continue to check the solicitation and presentation systems employed by low-spread foreign exchange traders.
- 2) For securities contracts for difference (CFD) transactions, there are plans to introduce margin regulations concerning OTC transactions for individuals. The FSA will examine each company's response, for their smooth and appropriate execution.

(5) Self-regulation in Type II Financial Instruments Business

For Type II financial instruments business, self-regulatory organizations do not currently exist, which leaves a gap in self-regulation. The FSA will focus on the situation of efforts for investor protection involving Type II financial instruments business, including the establishment of self-regulatory organizations.

(6) Ensuring Business Continuity

- 1) For financial instruments business operators which operate on customers' assets deposited with them, the FSA will respond with careful attention to the protection of customers' assets when there are any indications of discontinuance of business due to deteriorating financial conditions. For financial instruments business operators that do not operate with customers' assets deposited with them, the FSA will also deal with any information gained concerning the continuity of operations in an appropriate manner from the standpoint of client protection.
- 2) Information systems of financial institutions are the core infrastructure of their business operations, and with more advanced and complex systems, there are increasingly large impacts on customer transactions due to system failures. Considering that financial instruments business operators play important roles as market participants, the FSA will check that appropriate risk management is being conducted regarding the continuity of the information system in each company, under the guidance and commitment of management personnel.

(7) Response to Financial Crimes

- 1) There seems to be no end to the solicitation for unlisted shares and fraudulent solicitation for an interest in collective investment schemes (funds). In view of this, the FSA will respond to unregistered financial instruments business operators jointly with the police authorities. The FSA will appropriately deal with unregistered business operators located outside of Japan who solicit domestic investors for financial instruments.
- 2) For registered financial instruments business operators, inadequate responses have also been found due to such a lack of staff that the proper performance of business under the registration system is hampered. The FSA will respond harshly to such activities of registered financial instruments business operators, etc. in accordance with the laws and regulations.
- 3) To prevent crimes related to other financial transactions, particularly fraudulent solicitations for unlisted shares, collective investment schemes (funds) and other financial transaction related crimes, the FSA will encourage appropriate responses by related industry organizations (self-regulatory organizations) and financial instruments business operators.