

April 8, 2011

Securities and Exchange Surveillance Commission

## **Basic Securities Inspection Policy and Program for 2011<sup>1</sup>**

### **I. Basic Securities Inspection Policy**

#### **1. Basic Concept**

The mission of the Securities and Exchange Surveillance Commission (SESC) is to ensure the fairness and transparency of the Japanese markets and to protect investors. Securities inspection plays an important role to achieve this mission by on-site examinations of the business operations and financial soundness of financial instruments firms who act as market intermediaries.

In recent years, the regulatory environment surrounding the SESC's inspection has been changing dramatically.

As a result of a series of regulatory reforms, including the effectuation of the Financial Instruments and Exchange Act (FIEA), the scope of financial firms subject to the SESC's inspection has been expanded to include those engaging in the management and sale of interests of collective investment schemes (funds) (hereinafter referred to as "fund business operators") and credit rating agencies, leading to a sharp increase in the number of firms subject to inspection to around some 8,000. In addition, financial instruments and transactions with which financial firms deal have become more diverse and complex, as innovation is advancing and cross-border transactions and international activities of market participants such as investment funds have become common.

In order for the SESC's inspection to achieve its mission under these circumstances, it is essential to conduct efficient and effective inspection. From this perspective, it is appropriate to collect and analyze a variety of information concerning the firms subject to the SESC's inspection while taking account of their business types, sizes and other characteristics and of the market conditions at the time, and then decide which firms to inspect with a risk-based approach. It is also important that the SESC sharpens the

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<sup>1</sup> Corresponds to government's Fiscal Year 2011 (from April 1, 2011, to March 31, 2012).

focus of inspection and develops inspection techniques accordingly.

Based on the experience in the recent global financial crisis, where the bankruptcy of a large U.S. investment bank resulted in cross-border impacts on the financial systems, there has been progress in initiatives, under cooperation among securities regulators around the world, to capture businesses and risks that globally active and large-scale investment banks have as an entire group. In addition, consolidated regulation and supervision of securities companies was introduced in Japan in April 2011. Considering these developments, it is necessary to place more weight in inspection on verifying the appropriateness of the internal control and risk management systems of securities company groups that engage in large-scale and complex businesses as a group from the viewpoints of financial soundness of the entire group and of prevention of bankruptcy.

The advance of IT systems in recent years has enabled investors to have access to systems that process a large volume of diverse orders at high speed through the Internet and other means, and to transact various financial instruments. As a result, the participation of personal investors in financial transactions has increased remarkably, and the execution of massive and complex transactions by institutional investors has also been spreading, thereby making it more important than ever to ensure the reliability of IT systems as the financial infrastructure. Therefore, the SESC inspection needs to focus on the verification of the IT system risk management.

Securities inspections have strived to ensure investor protection through inspections of financial firms that have made registration based on the FIEA and thus are under the regulator's supervision. On top of that, however, recent years have seen increasing damages due to sales of unlisted stocks by non-registered firms and this phenomenon has become a social problem. In this context, the Consumer Basic Plan approved by the Cabinet in March 2010 raised the specific policy measure of utilizing applications for emergency court injunctions against FIEA violators (Article 192 of the FIEA) and associated investigations (Article 187 of the FIEA). From the viewpoint of investor protection it is appropriate that the SESC employs the authority for these applications and investigations to act against non-registered firms, in

close cooperation with relevant authorities.

Due to the impacts of the Great East Japan Earthquake and the subsequent electric power shortages, some securities companies have been forced to shrink or close their businesses. Also, based on the appeals in “Financial Measures in Response to Damage from the Tohoku-Pacific Ocean Earthquake 2011” published March 11, 2011, by the Minister of State for Financial Services and the Governor of the Bank of Japan, they are expected to take appropriate actions for victims and damaged companies. Given these unprecedented circumstances, it seems appropriate that securities inspections give due consideration to the impacts of the disaster on financial firms to be inspected. On the other hand, strict actions, in collaboration with relevant organizations, are required against any unfair transactions and misconducts that take advantage of the disaster, based on the March 13 “Statement by Shozaburo Jimi, Minister for Financial Services.”

Securities inspection needs to adapt to the changes in the environment, including the regulatory reforms in recent years, as described above. At the same time, it is essential to continue to enhance the examination of violations of laws and regulations, as well as the verification of the appropriateness of the internal control system behind individual problems, so as to ensure its ultimate objective: the fairness and transparency of capital markets and the protection of investors. Financial firms, as gatekeepers, are expected to do business in accordance with laws and regulations, as well as market rules standing on self-discipline, to ensure investor confidence in the markets. The SESC, through securities inspection, shall continue to take firm actions against illegal activities that undermine the confidence in market fairness and transparency or damage investors’ interests, and thus play a role to alert the markets.

## **2. Inspection Implementation Policy**

### **(1) Towards efficient and effective inspection**

#### **1) Risk-based inspection**

When deciding which firms to inspect, the SESC shall actively make use of and analyze information from supervisory departments and external information, and take due account of changes in the market environment

and the impacts of disasters, as well as individual firms' positions in the market and their inherent problems. In addition, when cross-cutting issues in the market have been identified, the SESC shall flexibly conduct special inspection, as necessary, against firms that face the issues in common.

The SESC shall identify, prior to inspection of individual firms, issues to be verified, and shall focus on them during its visits.

## **2) Implementation of effective inspection**

### **A. Inspection with prior notice**

In principle, the SESC continues to initiate inspections without prior notice. The SESC, however, shall give prior notice to the firms to be inspected on a case-by-case basis, taking comprehensive account of the characteristics of their businesses, the focuses and the efficiency of inspection, and the reduction of burdens on the firms to be inspected.

### **B. Verification of the appropriateness of the internal control systems**

When any problems in firms' business operations have been identified, the SESC shall examine the appropriateness and effectiveness of their internal control systems and risk management systems (hereinafter referred to as the "internal control systems") behind them. The SESC shall also pay attention to whether the senior management has been appropriately involved in the development of the systems.

Especially, as far as securities company groups that engage in large-scale and complex businesses as a group are concerned, the SESC shall, from a forward-looking perspective, focus on the appropriateness of their internal control systems, whose importance is deemed very high given their positions in the market and the characteristics of their businesses, based on the "Inspection Manual for Financial Instruments Business Operators" revised in April 2011. It shall also perform appropriate inspections in response to the introduction of consolidated regulation and supervision of securities firms.

### **C. Enhancement of interactive dialogue**

The SESC shall strive to share the recognition of deficiencies in business operations with the firms under inspection through

interactive dialogue. In particular, the SESC shall affirm the senior management's recognition of the problems identified through dialogue as they are responsible for the development of the internal control systems, and encourage them to make improvement efforts.

### **3) Enhancement of cooperation with relevant departments/organizations**

- Regarding supervisory departments of the Financial Services Agency (FSA) and Local Finance Bureaus, the SESC shall continue to cooperate with them by sharing concerns and information by exchanging information useful for inspection obtained in the course of supervision and vice versa. In particular, for securities company groups which engage in large-scale and complex businesses as a group, the SESC shall seek seamless cooperation between its on-site inspections and the supervisory departments' off-site monitoring.
  
- With respect to the Inspection Bureau of the FSA, the SESC shall initiate inspections of financial firms that constitute a financial conglomerate in collaboration with them, if deemed necessary, and shall exchange information, in the light of the smooth inspections of the financial firms within the same group and of sharing regulatory concerns.
  
- As to Self-Regulatory Organizations (SROs), the SESC shall further strengthen coordination between its inspection and their examinations of their member firms so as to increase the effectiveness of the multilayered oversight activities over the financial firms. From this perspective, the SESC shall promote cooperation with the SROs through the coordination of inspection programs, exchange of information, and the training of inspectors.
  
- With regards to overseas securities regulators, the SESC shall strengthen cooperation on inspections of foreign financial firms operating in Japan and Japanese financial firms that have overseas offices through the exchange of necessary information. In addition, the SESC shall enhance collaboration with the major overseas securities regulators through active involvement in the "Supervisory

Colleges” for globally active and large-scale securities firms.

- Concerning the supervisory departments and disclosure oversight departments of the FSA and the Local Finance Bureaus, as well as investigative authorities, the SESC shall further promote cooperation with them, in response to fraudulent practices by fund business operators, sales and solicitation of unlisted stocks by non-registered firms, and solicitation without necessary filing by the issuers of those stocks.

#### **4) Revision of the inspection manual**

In April 2011, the SESC revised the “Inspection Manual for Financial Instruments Business Operators,” which took effect thereafter. The revisions include additions of examination items in relation to the consolidated capital adequacy regulation ratios in response to the introduction of consolidated regulation and supervision of securities companies, as well as internal control systems of securities company groups that engage in large-scale and complex businesses as a group. Furthermore, with the development of self-regulations on sales and solicitation of OTC derivatives for personal investors, compliance with their rules has been included in the Manual.

The SESC shall continue to revise the Manual in accordance with regulatory changes so as to improve the transparency and predictability of its inspections.

### **(2) Focuses of inspection**

#### **1) Verification of the exercise of gatekeeper functions**

##### **A. Market intermediary functions of financial instruments firms**

To develop and maintain fair, transparent and high-quality financial and capital markets, it is extremely important for financial instruments firms to fully exercise their functions of preventing persons and entities that intend to abuse and misuse the markets from participating in them, through customer management, surveillance of transactions, and underwriting examination. The SESC therefore shall focus on whether financial instruments firms are properly playing these roles.

As part of these, the SESC shall review how inspected firms are developing their systems to prevent anti-social forces from making transactions with them through information gathering. The SESC shall examine whether the firms conduct customer identification properly when a new account is opened or when identity theft is suspected and whether systems are established for adequate reporting of suspicious transactions, considering the importance of appropriate implementation of these duties from the perspective of anti-money laundering and combating terrorist financing promoted under international cooperation.

Furthermore, to encourage the smooth functioning and sound development of capital markets, the SESC shall examine whether underwriting business, including underwriting examination, information control, surveillance of transactions, and distribution, are appropriately executed from the viewpoint of ensuring the fairness and transparency of capital markets and protecting investors. Especially, given the recent situations regarding new listings, the SESC shall verify whether examination systems for underwriting IPOs are functioning appropriately. In addition, as for financial instruments firms that also arrange and distribute securitized instruments and high-risk derivatives products, the SESC shall review their risk management and sales management systems.

#### **B. Management of undisclosed corporate information (Prevention of unfair insider trading)**

In order to prevent unfair insider trading, the SESC shall focus on whether financial instruments firms strictly control undisclosed corporate information. Specifically, the SESC shall verify whether the firms have developed effective management systems with regard to the registration of undisclosed corporate information such as public stock offerings by listed companies, information firewalls, and the surveillance of transactions by insiders and the financial firms' senior management and employees.

#### **C. Conduct that may hinder fair price formation**

Fair price formation is the foundation for the fairness and

transparency of the market and serves as the basis of investor confidence in the market. The SESC shall not only verify whether practices that may hinder fair price formation are being employed but will also examine the transaction surveillance systems of financial instruments firms to prevent such practices. In doing so, the SESC shall examine whether effective transaction surveillance from the viewpoint of preventing market misconduct is being done. Especially, surveillance focusing on specific dates, such as a pricing date for a public stock offering or a specific trading time such as just before closing, and customers who repeatedly place large orders that could affect price formation, as well as whether measures are taken to identify the original customers for orders consigned from foreign related entities. The SESC shall also examine management systems (including the management of delivery failures) for short selling regulations, such as checking the indication of short selling, price regulations, and prohibition of naked short selling.

In particular, as far as financial instruments firms operating online trading or providing electronic facilities for DMA (direct market access) are concerned, the SESC shall continue to examine whether they have established effective trade surveillance systems that take account of the electronic transactions' nature that customer orders feed directly into the market, considering the recent market manipulation cases with "misegyoku" (false orders to manipulate prices) using Internet transactions.

## **2) Examination of internal control systems**

### **A. Internal control systems**

While conducting the examination to detect illegal conduct, the SESC shall also focus on the appropriateness of the internal control system and the risk management system, including financial soundness, in light of the characteristics of the inspected firms. In particular, regarding securities company groups that engage in large-scale and complex businesses as a group, the SESC shall examine the appropriateness of the internal control systems for the entire group from a forward-looking perspective so as to prevent risks related to their business operations and financial positions from materializing.

## **B. Management of IT system risk**

In recent years, financial instruments firms have become increasingly dependent on IT systems in their business operations, while personal investors' participation in securities transactions and FX trading on the Internet has been spreading. Thus, IT systems have become an important infrastructure of financial transactions.

Under these circumstances, it is very important to secure the stability of IT systems from the viewpoint of protecting investors and ensuring public trust in the market and in financial instruments firms. The SESC shall verify the appropriateness and effectiveness of the management of IT system risk to prevent it from crystallizing, including the prevention of erroneous order placements, IT system troubleshooting, information security management, and oversight of outsourcing. The SESC shall also examine the involvement of senior management in the development of the IT system risk management.

## **3) Examination from the viewpoint of investor protection**

### **A. Solicitation for investment**

To protect investors and secure genuine and fair sales and solicitation operations, the SESC shall focus on whether financial instruments firms are soliciting customers for investment in an appropriate manner and are taking good care of them.

Regarding the status of solicitation for investment, the SESC shall examine, from the viewpoint of the suitability rule, whether financial instruments firms are appropriately soliciting for investment in light of customers' knowledge, experience, and holding assets, as well as investment purpose, and whether they are fully accountable for their solicitation in accordance with the characteristics of individual customers.

The SESC shall also examine whether, upon sales and cancellations of investment trusts (including switching), appropriate explanations are being provided regarding important information that affects customers' investment decisions, such as profits/losses, commissions and investment trust fees and other costs. For OTC derivatives transactions and complex structured bonds similar to OTC

derivatives transactions, the SESC shall examine whether appropriate explanations are being provided regarding important risks and other factors that affect decisions for investment in such products.

In addition, the SESC shall verify whether advertisements that are widely exposed to investors do not include misleading indications regarding investment returns, market factors, and the situations of transactions. The SESC shall also examine the complaint handling system, which is important for investor protection.

#### **B. Appropriateness of asset management business**

While asset management firms are commissioned by investors to manage their assets for their interests, it is very difficult for the investors to know the actual situation of the assets managed. Therefore, from the viewpoint of investor protection, the SESC shall examine asset management firms' compliance with the relevant laws and regulations, including the fiduciary duty and due care of a prudent manager, and the effectiveness of their systems for managing conflicts of interest in relation to transactions with interested parties and the due diligence function.

#### **C. Compliance with laws and regulations by fund business operators**

For fund business operators (including Specially Permitted Business Notifying Firms for Qualified Institutional Investors), recent inspections have found many legal violations, such as inappropriate account separation between fund's own money and investors' (diversion of investors' money and unexplained expenditure), false explanations and notices, misleading displays, name-lending to non-registered firms, and Specially Permitted Business Notifying Firms selling and managing funds without satisfying the requirements of Specially Permitted Businesses for Qualified Institutional Investors. The SESC, therefore, shall continue to select firms to be inspected on a risk basis, and examine their legal compliance, including the appropriateness of business operations and account separation.

#### **D. Compliance with laws and regulations by investment advisories/agencies**

Regarding investment advisories/agencies, many legal violations have been identified in recent inspections, including engagement in non-registered businesses, name-lending to non-registered firms and inappropriate provision of information to customers, due to the remarkable lack of basic legal knowledge and perception of the need for legal compliance among their officers and employees. The SESC, therefore, shall continue to select firms or persons to be inspected on a risk basis, and focus on their legal compliance.

#### **E. Response to non-registered firms**

In response to serious FIEA violations, such as sales and solicitation of unlisted stocks and funds by non-registered firms, the SESC shall strengthen cooperation with supervisory departments, disclosure oversight departments, and investigative authorities, and take appropriate action as needed, employing applications for emergency court injunctions and associated investigations.

### **4) Others**

#### **A. Functions of SROs**

As for SROs, the SESC shall examine whether self-regulatory operations are effective and functioning appropriately, as well as whether they have systems necessary for exercising their functions properly. Specifically, the SESC shall conduct verification with regard to the establishment of their self-regulatory rules for their members and their regulatory enforcement, such as on-site and off-site reviews, penalties, and listing examination, as well as transaction surveillance. In the verification of listing examination, the SESC shall focus on SROs' measures to prevent anti-social forces from intervening in the financial and capital markets, including the collection of information on the involvement of anti-social forces in the issuing and listed companies. Furthermore, in light of the significance of financial instruments exchanges as the market infrastructure, the SESC shall focus on their systems for ensuring smooth and appropriate management of the financial instruments markets, such as IT system risk management.

## **B. Business management of credit rating agencies**

Regarding credit rating agencies, which became subject to securities inspection in April 2010, the SESC shall examine the appropriateness of their business management systems with reference to the Inspection Manual for Credit Rating Agencies published in March 2010.

## **C. Response to inappropriate transactions and legal violations taking advantage of disasters**

To prevent inappropriate transactions and legal violations taking advantage of disasters, the SESC shall perform thorough surveillance and take strict action under close cooperation with relevant authorities.

## **II. Basic Securities Inspection Program**

### **1. Basic Concept**

(1) The SESC shall formulate an inspection program based on the following principles, while taking account of the characteristics of financial instruments firms' businesses. It should be noted that there can be some exceptions to these principles in response to a change in market environment, impacts of disasters, and factors related to specific firms.

1) Regarding firms that underwrite, trade or solicit liquid financial instruments, such as listed securities and firms that manage assets on commission from investors for their interests, the SESC shall in principle examine their business operations and financial soundness on an ongoing basis in light of the importance of their roles in the market. In addition, for credit rating agencies that assign credit ratings that greatly affect investment decisions of investors and that publish and provide them to users, the SESC shall in principle examine their business operations on an on-going basis in light of their roles as information infrastructure in the financial and capital markets.

2) Regarding firms other than those specified in 1) above (e.g., firms that deal with illiquid financial instruments or firms that only conduct investment advisory business (excluding firms that fall into 3) below)), the SESC shall judge inspection priority based on information from

supervisory departments and external sources in light of the huge number of firms subject to inspection.

3) In response to serious violations of the FIEA by non-registered firms, the SESC shall appropriately execute investigations for applications for emergency court injunctions, based on information from supervisory departments and external sources.

(2) The SESC shall work with securities and exchange surveillance departments of the Local Finance Bureaus to conduct efficient and effective inspection through active use of joint inspections and the exchange of inspectors. The SESC shall also support the securities and exchange surveillance departments through sharing inspection techniques and information, and thereby shall conduct inspections in an integrated manner.

## 2. Basic Securities Inspection Program

Type I Financial Instruments Businesses Operators (including Registered Financial Institutions), Asset Management Firms, and Credit Rating Agencies	To be inspected on an on-going basis (Note)
Type II Financial Instruments Businesses Operators, Investment Advisories/Agencies, Specially Permitted Business Notifying Firms for Qualified Institutional Investors, and Financial Instruments Intermediaries	To be inspected on an on-going basis
SROs	To be inspected as necessary
Non-registered firms	To be inspected on an on-going basis

Note: The number of firms to be inspected is shown in normal years, but due to the impacts of the Great East Japan Earthquake, it is difficult to show it at the current moment.