Chapter 4
Inspections

I. Outline

1. Significance of inspections and parties inspected

The SESC conducts on-site inspections of securities companies to supervise compliance with laws and regulations concerning the maintenance of fairness in securities and financial futures transactions. SESC inspections are carried out under the authority delegated by the Minister of Finance as prescribed in the SEL, LFSF and FFTL.

The objective of SESC inspections is to protect investors and public interests. SESC inspections support the Minister of Finance in enacting necessary measures and policies as regards securities companies.

Specifically, the following institutions are subject to SESC inspection:

Securities companies and their parent financial institutions	(SEL, Article 56)
Financial institutions licensed to provide securities services	(SEL, Article 66)
Securities dealers associations	(SEL, Article 79(15))
Stock exchanges	(SEL, Article 154(2))
Branches of foreign securities companies in Japan	(LFSF, Article 21(2))
Financial futures exchanges and their members	(FFTL, Article 52(2))
Financial futures dealers	(FFTL, Article 77(2))
Financial futures dealers associations	(FFTL, Article 90(2))

Note: Information in parentheses indicates provisions for delegation of inspection authority.

2. Scope of inspections

The scope of SESC inspections is regulated in the Cabinet Order concerning the maintenance of securities transaction fairness. This scope mainly includes inspections of cases of loss compensation, market manipulation, insider trading, and acts prohibited to securities companies and their officers (for example, discretionary trading account transactions, solicitation with definitive predictions, and solicitation with promises of profit).

II. Basic Policy and Plan of Inspections

Activities leading to inspections are carried out on an SESC-year basis between July 1 and June 30.

To strategically manage and conduct all inspections by the SESC and, under SESC authority, by directors-general of regional finance bureaus, basic policies and plans for inspections are established each SESC year.

Basic policies for inspections determine priority inspection topics and other topics that form the basis of inspections. Basic plans for inspections determine matters such as the numbers and kinds of domestic and foreign securities companies, and financial institutions licensed to provide securities services to be inspected during the year.

The SESC's basic policy and plans for inspections during SESC year 1993 (this SESC year) were decided as summarized below on July 23, 1993:

Basic policy and plan of inspections in SESC year 1993

1. Basic policy of inspections

While financial and capital markets have been deregulated and globalized, resulting in more complicated and diversified securities activities, difficult situations are still being encountered by securities companies. Such difficulties include the slow pace of recovery in the Japanese stock market, which has been caused by decreasing corporate earnings.

In addition, because of reforms in financial and securities transaction systems, subsidiaries of financial institutions can now participate in the securities business. On the other hand, scandals involving employees of securities companies are continuing, and recovering investor confidence has become an important task.

Given this situation, the priorities in inspections of securities and related companies for this SESC year were set forth as described below and with the goal of conducting strict and precise inspections in cooperation with the Financial Inspection Department of the Ministry of Finance.

Moreover, to promote the quality of inspections it was decided to continually reinforce and improve the SESC's inspection organization.

(1) Priorities for inspections of securities companies

① To maintain fairness in securities transactions, inspections were to examine from various points of view the compliance with market rules.

② Inspections were to sufficiently check the sales practices of securities companies, including investment solicitation methods, to ensure sound sales practices.

③ To maintain the credibility of securities services, inspections were to fully examine internal control systems and effectiveness.

(2) Priorities for inspections of financial futures dealers

To maintain fairness in financial futures transactions, inspections of dealers were designed to examine compliance with market rules as well as to fully comprehend the sales practices of said dealers as regards investment solicitation.

2. Basic inspection plans

(1) Inspections of securities companies

- Domestic securities companies: 76
- Foreign securities companies: 8

Notes:

1. *In addition to the above domestic securities companies, 17 individual branch offices of securities companies were to be inspected. Conducting inspections of subsidiaries of financial institutions depended on factors including the status of their operations.*
2. *In principle, SESC inspections were to be conducted in conjunction with the Financial Inspection Department.*
3. *The above number of companies to be inspected was the initial figure and was subject to change according to various factors.*

- Financial institutions licensed to provide securities services

In principle, SESC inspections were to be conducted in conjunction with the Financial Inspection Department. If necessary, said inspections were to be conducted at any time.

(2) Inspections of financial futures dealers

- Financial futures dealers

In principle, inspections were to be conducted in conjunction with the Financial Inspection Department. If necessary, said inspections were to be conducted at any time.

III. Number of Inspections and Related Matters

1. Inspection status

Following are the inspections conducted by the SESC and regional finance bureaus during this SESC year.

(1) Inspections of securities companies

This SESC year, the SESC and regional finance bureaus commenced inspections of 87 securities companies and 13 financial institutions licensed to provide securities services.

The SESC commenced inspections of nine domestic securities companies, nine branches of eight foreign securities companies, and three financial institutions licensed to provide securities services. Regional finance bureaus commenced inspections of 70 domestic securities companies and 10 financial institutions.

By SESC year-end (June 30, 1994), inspections had been completed on 61 domestic securities companies, nine branches of eight foreign securities companies, and nine financial institutions (Table 2). An inspection is completed when the Notification of the Conclusion has been presented to the company concerned.

In addition, inspections commenced in SESC year 1992 that had not been completed by June 30, 1993, on 35 domestic securities companies and four financial institutions licensed to provide securities services were completed this SESC year.

Following SESC recommendations based on these inspections, the Minister of Finance enacted disciplinary actions, such as business suspensions, against 12 companies for grave violations of laws and regulations by the companies themselves and their officers (detailed in Chapter 2).

Problems found through these inspections were reported to the Ministry of Finance, which then issued improvement directives.

(2) Inspections of financial futures dealers

This SESC year, inspections were carried out in conjunction with securities inspections.

Reference

Following are the results of inspections conducted by the SESC and regional finance bureaus during SESC year 1992.

(1) Inspections of securities companies

Inspections were commenced on 84 securities companies and 11 financial institutions licensed to provide securities services.

By inspecting organization, the SESC commenced inspections of nine domestic securities companies, seven branches of six foreign securities companies, and three financial institutions licensed to provide securities services. Regional finance bureaus commenced inspections on 69 domestic securities companies and eight financial institutions licensed to provide securities services.

By SESC year-end (June 30, 1993), inspections had been completed on 43 domestic securities companies, seven branches of six foreign securities companies, and seven financial institutions licensed to provide securities services. The results of inspections were presented to the subject companies.

Following SESC recommendations based on the above inspections, the Minister of Finance enacted disciplinary actions, such as business suspensions, against two companies for grave violations of laws and regulations by the companies themselves and their officers.

(2) Inspections of financial futures dealers

As in this SESC year, inspections in SESC year 1992 were conducted in conjunction with securities inspections.

Table 2: Inspection Status

	SESC Year 1992	SESC Year 1993	Total
Securities companies (total)	84 (69)	87 (70)	171
Domestic	78 (69)	79 (70)	157
Foreign	6	8	14
Financial institutions licensed to provide securities services	11 (8)	13 (10)	24

Notes:
1. *Numbers in parentheses indicate inspections conducted by regional finance bureaus.*
2. *The number of inspections is based on inspections commenced during each SESC year.*

2. Total personnel per inspection

This SESC year, 111 man-days were assigned per inspection (on-site basis) for domestic securities companies, 43 man-days for foreign securities companies, and 20 man-days for financial institutions licensed to provide securities services (Table 3).

Table 3: Total Personnel per Inspection

(Unit: man-days/inspection)

Category	SESC Year 1992	SESC Year 1993
Securities companies		
Domestic	103	111
Foreign	60	43
Financial institutions licensed to provide securities services	16	20

IV. Results of Securities Company Inspections

Inspections of securities companies this SESC year were conducted primarily to examine compliance with transaction rules, sales practices and internal control systems.

Following is a summary of problems found during inspections completed this SESC year, including those commenced in the previous SESC year. Some of these problems are described in Chapter 2.

(1) *Concerning the observance of transaction rules, the following problems were found in some securities companies, including inappropriate solicitation and transactions for the purpose of improving sales results.*

① Acceptance of discretionary trading account transaction contracts	(legal violation)
② Guaranteeing loss compensation before the amended SEL took effect	(legal violation)
③ Making untrue statements concerning securities transactions	(legal violation)
④ Solicitation with the promise of providing profit	(legal violation)
⑤ Securities transactions to deliberately manipulate the market	(legal violation)
⑥ Securities transactions for speculative profit	(legal violation)
⑦ Loss compensation before the amended SEL took effect	(violation of government directive)
⑧ Bond transactions at prices apart from market value	(violation of self-regulatory rules)
⑨ Negotiated transactions between registered sales representatives and customers	(violation of self-regulatory rules)
⑩ Lending and borrowing names for securities transactions	(violation of self-regulatory rules)
⑪ Accepting orders for transactions made under assumed names	(violation of self-regulatory rules)

(2) *The following problems, including inappropriate solicitation amidst the increasing number of sales of investment trusts of foreign securities and inappropriate solicitation neglecting the will of investors for the purpose of seeking improved sales results, were found in some securities companies.*

① Inappropriate investment solicitation in the sale of investment trusts
- Lack of knowledge of interest rate and exchange risks by sales representatives, and insufficient explanations
- Solicitation based on imprecise internal sales instruction information
- Short-term transactions with losses that are guided by sales representatives and neglect the will of investors

② Frequent transactions of stocks and convertible bonds in short terms that are guided by sales representatives and neglect the will of investors

③ Excessive credit given (deposit shortages of additional amounts as consignment guarantee money, and long-term subrogation of losses from the settlement of margin transactions)

(3) *Generally speaking, internal control systems in most companies have improved under efforts to prevent the reoccurrence of scandals. However, some such systems are not yet functioning well because of insufficient awareness on the part of companies of the systems and the compliance with laws and regulations. The following problems have been found:*

① Failure to report scandals, customer problems and accidents related to securities transactions;

② Abandonment of supervised accounts tagged by in-company management systems; and

③ Inappropriate treatment of returned transaction reports.

Reference 1

Facts regarding the above problems are described below. (Facts in cases in which the SESC has already made recommendations are described in Chapter 2.)

- Cases concerning compliance with transaction rules

1. *Loss compensation before the amended SEL took effect*

Securities company A compensated its customers for securities transaction losses by letting said customers purchase foreign bonds at prevailing market prices and then repurchasing them at prices apart from the market prices.

2. *Trading in bonds at prices apart from market value*

Based on the request of a customer seeking to decrease the value of foreign bonds with hidden losses, securities company B purchased the bonds at prices exceedingly higher than market value, then sold the same kinds of bonds at equally high prices.

3. *Prior negotiation of transactions between registered sales representatives and customers*

A customer requested an employee of securities company C to redeem an investment trust, though the customer's reasons did not fall within the acceptable purchase conditions of securities company C during the closed period. The employee purchased the investment trust with his own funds after the customer made a claim because insufficient explanations were given concerning purchase conditions during the closed period.

4. *Lending and borrowing names in securities transactions*

Seeking improved sales results, a sales representative of securities company D purchased an investment trust under his own account by borrowing the names of existing customer accounts.

The sales representative concerned also carried out transactions allowing the customer to use his personal account or accounts under the names of people close to him, such as relatives. These transactions occurred because the customer wished to conceal his name and depress the carry-over rate from existing investment trusts.

5. *Accepting orders for transactions under fictitious names*

Some officers and sales representatives of securities company E accepted orders from customers for the purchase of securities at their offering. However, said officers and sales representatives knew that the customers were using numerous accounts under other people's names as a means to increase their chances of winning purchasing rights through the lottery system.

- Cases concerning sales practices

1. *Inappropriate solicitation for investment trust sales (1)*

When securities company F sold an investment trust comprising foreign securities and derivatives offering relatively high returns (better prices when interest rates rise, but holding a high risk of sharp price drops when interest rates fall), it emphasized high returns and investment safety.

Later, the base price of the investment trust fell substantially following a sharp drop in interest rates. At many of the company's sales offices, where the above explanations were given to customers, problems arose with customers, and purchases occurred during the closed period because the customers were given inappropriate risk information.

2. Inappropriate solicitation for investment trust sales (2)

Securities company G sold an investment trust comprising foreign bonds (Canadian dollar denominated) offering relatively high yields. (Exchange risks were hedged with U.S. dollars, for which the contract cost was lower in forward exchange transactions.)

In soliciting for this sale, sales representatives from some branches changed the internal-use sales instructions from the headquarters to emphasize the security of the principal and high returns. This act was misleading, giving the appearance that no exchange risk was involved.

The exchange risk was not hedged because linkages weakened between the U.S. dollar—yen, and the Canadian dollar—yen, and the base price had dropped. Troubles then arose with customers given inappropriate explanations, and purchases of the investment trusts by the company occurred during the closed period.

- Internal control systems

1. Failure to report securities incidents (1)

A sales manager at a branch office of securities company H was reported by a member of his staff for carrying out discretionary trading accounts transactions for his customer. However, said sales manager reported the transaction with this customer as legal after an inquiry from the headquarters office. As a result, securities company H failed to report this incident to the JSDA.

2. Failure to report securities incidents (2)

Securities company I traced an incident in which a sales representative at a branch office had carried out speculative transactions on his own account by borrowing from customers' accounts. However, securities company I neglected to report the incident to the JSDA because the sales representative concerned had compensated the customer's account for the loss from his own account, without recording a loss to the company.

3. Trading under supervised accounts tagged by in-company management systems but allowed to remain active

Securities company J follows a system whereby its headquarters Sales Management Division notifies branches of supervised accounts tagged because of frequently repeated transactions. However, some of securities company J's branches failed to take appropriate measures upon receiving notice of such supervised accounts. Moreover, some employees had no knowledge that such an account supervision system was in effect.

4. Inappropriate treatment of transaction reports

Some sales branches of securities company K, after transaction reports were returned undelivered because of unknown addresses and other factors, had not appropriately examined the reasons for nondelivery and did not resend the reports, even after the addresses were updated. Some reports were returned because the related transactions were carried out under assumed names.

Reference 2

In the same manner as in SESC year 1993, in SESC year 1992 inspections were conducted by putting priority on such items as transaction rules, sales practices and internal control systems.

Following is a summary of the year's results:

(1) The SESC found the following problems regarding the compliance with transaction rules by some securities companies:

① Solicitation with promises to provide profit

② Accepting orders to trade convertible bonds in an inappropriate manner

③ Accepting discretionary trading account transactions

④ Accepting orders for transactions under assumed names

⑤ Swapping bond transactions at prices apart from prevailing market prices

⑥ Loss compensation to specific customers before the amended SEL took effect

Following SESC recommendations to the Minister of Finance, disciplinary actions were taken in cases of grave violations of laws and regulations. These actions, which included the suspension of business activities, were levied in cases of solicitation with the promise to provide profits, accepting orders to trade convertible bonds in an inappropriate manner, and accepting discretionary trading account transactions.

(2) The SESC found the following sales practice problems at some securities companies:

① Excessive credit given (deposit shortages of additional amounts as consignment guarantee money and long-term subrogation of losses from the settlement of margin transactions)

② Excessive roll-over investment trust transactions and short-term sales of investment trusts with losses promoted by sales representatives, as well as inappropriate purchase solicitation for investment trusts for unacceptable reasons during closed periods

③ Frequent short-term securities transactions guided by sales representatives

④ Creating investment information without objective viewpoints

(3) The SESC found the following problems concerning internal control systems at some securities companies:

① Failure to report scandals, customer problems and accidents related to securities transactions

② Accepting orders for, or deliveries to, persons other than the customers concerned

③ Writing cash receipts and contract documents by proxy when sales representatives agreed to set up margin transaction accounts on customers' behalves

V. Results of Inspections of Financial Institutions Licensed to Provide Securities Services

As with securities companies, financial institutions were inspected for compliance with transaction rules and other important matters. Few problems were found during these inspections, with the exception of cases of neglecting to prepare contract documents for bond repurchase transactions.

Reference

Swapped bond transactions at prices apart from prevailing market prices were uncovered at some financial institutions during inspections in SESC year 1992.

VI. Results of Inspections of Financial Futures Dealers

During securities inspections, no problems were found regarding sales practices, including solicitation methods, or compliance with market rules.

Reference

No problems were found during SESC inspections in SESC year 1992.

Chapter 5
Market Surveillance

I. Outline

1. Significance of market surveillance

The objective of market surveillance is to ensure securities transaction fairness and investor protection. The SESC ensures this objective by collecting detailed reports about securities transactions and necessary materials for daily market surveillance from securities companies and SROs. These activities are carried out on the following institutions under the authority delegated by the Minister of Finance:

Securities companies and their parent financial institutions	(SEL, Article 56)
Financial institutions licensed to provide securities services	(SEL, Article 66)
Securities dealers associations	(SEL, Article 79(15))
Stock exchanges	(SEL, Article 154(2))
Branches of foreign securities companies in Japan	(LFSF, Article 21(2))
Financial futures exchanges and their members	(FFTL, Article 52(2))
Financial futures dealers	(FFTL, Article 77(2))
Financial futures dealers associations	(FFTL, Article 90(2))

Note: Information in parentheses indicates provisions for delegation of market surveillance authority.

2. Scope of market surveillance

As with the scope of inspections, the Cabinet Order that refers to the maintenance of fair transactions regulates the scope of market surveillance according to the authority to collect reports and related materials.

3. Emphasis of market surveillance

Market surveillance emphasizes the following points:

① Stock price movements of convertible bond issues before, on and after conversion price calculation dates (during financing)
② Stock price movements before and after corporate accounting periods
③ Stock price movements before and after cross-transactions
④ Stocks experiencing sharp price rises or declines
⑤ Stocks for which information appeared that significantly influenced price formation
⑥ Information provided by sources in the general public

To prevent the occurrence of unfair transactions, additional emphasis is placed on the following points:

① The involvement of securities companies, which have heavier responsibilities as intermediaries than those of investors
② Whether the above involvement violates securities transaction laws and regulations
③ Whether the market surveillance functions of SROs are functioning appropriately

The SESC also maintains close relationships with the market surveillance sections of SROs by exchanging necessary information on a regular basis or upon request.

If necessary, based on the results of market surveillance, the SESC conducts on-site inspections.

II. Results of Market Surveillance

1. Number of cases

Market surveillance activities include collecting market and corporate information, requesting necessary materials from or interviewing securities companies and SROs. These activities are conducted to check daily market trends. In some cases, closer market surveillance is conducted for specific periods of time with regard to specific matters.

In SESC year 1993, cases of detailed market surveillance were as follows:

Related to manipulation:	162 cases
Related to insider trading:	50 cases
Related to other items:	5 cases

Market surveillance by the SESC and regional finance bureaus was conducted as follows:

Conducted by the SESC:	102 cases
Conducted by regional finance bureaus:	115 cases

Table 4: Results of Market Surveillance

(Unit: cases)

Category		SESC Year 1992	SESC Year 1993
Related to manipulation		154	162
Related to insider trading		12	50
Others		4	5
Total		170	217
	Surveillance by regional finance bureaus	95	115

2. Summary of surveillance results

In the current atmosphere of worsening business results, the number of surveyed cases of manipulation has been increasing because, under the market condition of sluggish corporate business results, sharp rises or drops in stock prices were observed on stocks having particular material news or being under tight market condition in demand and supply. In addition, surveyed cases of insider trading have also been increasing, as many companies revised their income estimates as a result of massive business losses, which often affected their stock prices significantly.

Although SESC surveillance has determined no problems in most cases, through its surveillance activities the Commission attempts both directly and indirectly to prevent unfair transactions.

Surveillance cases during SESC year 1993 were as follows:

Surveillance related to manipulation

(1) Stock-issuing company A experienced a sharp drop in the price of its stock in the period between the date of the board decision to issue and the date of the exercise price calculation for warrant bonds. This event caused a sharp rise in the stock price shortly after the exercise price was calculated.

(2) The price of stock issued by company B rose sharply immediately following the transfer of stock holdings by a major shareholder. This stock was sold following the price increase.

Surveillance related to insider trading

(1) Stock-issuing company C announced that it would adjust its results forecasts downward. Executives of the company sold their stocks before the public announcement.

(2) Stock-issuing company D announced a stock split with high ratio. Residents near the site of the company's operations bought the company's stocks before the public announcement.

(3) Stock-issuing company E announced that it would adjust its results forecasts upward. Executives of the company sold their stocks before the public announcement.

Surveillance related to other items

(1) Securities company F was involved in cross-transactions to trade convertible bonds issued by company G. Immediately before trading began, securities company F bought securities company G's stocks in its own account.

(2) An imprecisely worded document referring to stock-issuing company H was sent to a number of unnamed investors. Immediately following the incident, the stock trading volume rose sharply and continued increasing.

Reference

The following cases were surveyed during SESC year 1992:

(1) Financing-related manipulation was suspected in a case in which issuing company A's stock price fell sharply, then rose abruptly on the date when the exercise price of the company's warrant bond issue was calculated.

(2) Manipulation to counter fiscal year-end account settlement was suspected in a case in which stock held by company B rose sharply despite the market's prevailing downward trend.

(3) Insider trading was suspected in a case in which stock-issuing company C announced such material facts as a downward adjustment of its results forecasts. A director of this company sold his stock before this announcement.

Chapter 6
Inspections of Financial Institutions by the Minister of Finance

The Minister of Finance must seek the opinions of the SESC regarding inspection plans and basic matters. This provision also obliges the Minister of Finance to ask for SESC advice and enables the SESC to make necessary proposals regarding the policies of inspecting financial institutions, foreign currency exchange and securities companies (in particular, financial soundness). Proposals, made in view of the value of objective opinions by non-administrative personnel, include judgments on which points to emphasize, as well as on the basic plans of inspections, including the number of inspections to be conducted.

The Minister of Finance must also report to the SESC on a quarterly basis on the manner in which inspections are carried out. As necessary, the SESC can make proposals to the Minister of Finance concerning the operation and policies of inspections of financial institutions.

In SESC year 1993, no proposals on inspection operations were deemed necessary.