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
Japan Securities Dealers Association	SEL Article 79(15)
Stock exchanges	SEL Article 154(2)
Branches of foreign securities companies	LFSF, Article 21(2)
Financial futures exchanges and their members	FFTL, Article 52(2)
Financial futures dealers	FFTL, Article 77(2)
Japan Financial Futures Dealers Association	FFTL, Article 90(2)

Note ①: Information in parentheses indicates provisions for delegation of inspection authority.

Note ②: The SESC's authority to inspect and seize reports and materials is entrusted to directors-general of regional finance bureaus, except in the case of securities companies and financial institutions under supervision of the Ministry of Finance. (However, if necessary the SESC may exercise said 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 and guarantees, market manipulation, insider trading, and acts prohibited to securities companies and their officers and employees (for example, discretionary trading account transactions, solicitation with definitive predictions, and solicitation with promises of special profit).

II. Basic Policy and Plan of Inspections

Activities related 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 1994 (this SESC year) were decided as below on June 28, 1994:

Basic policy and plan of inspections in SESC year 1994

1. Basic policy of inspections

While financial and capital markets have been deregulated and globalized, resulting in more complicated and diversified securities activities, expectations of business recovery is supporting steady strength in the stock market. In addition, as a result of various reforms in financial and securities transaction systems, to stimulate the stock market the number of subsidiaries of financial institutions now participating in the securities business is growing, and new transaction starts and marketing activities are increasing.

Meanwhile, cases were acknowledged in some companies of investment solicitation and inappropriate transactions ignoring the will of investors for the purpose of increasing sales results. Also, regarding internal control systems overall improvement is being seen, but some cases were acknowledged of insufficient awareness of regulations and/or internal control systems, meaning that not all such systems are functioning sufficiently.

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 while promoting flexibility for more effective inspections.

(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:** 79

❑ **Foreign securities companies:** 6

Notes:

1. *In addition to the above domestic securities companies, 23 individual branch offices of securities companies were to be inspected.*
2. *If SESC inspections are deemed necessary based on various kinds of information, in addition to the above inspections, inspections will be implemented flexibly.*
3. *Regarding securities companies that are subsidiaries of financial institutions, fire wall and other inspections are carried out an early stage following establishment.*
4. *In principle, SESC inspections were to be conducted in conjunction with those of the Financial Inspection Department.*
5. *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 those of the Financial Inspection Department. If necessary, said inspections were to be carried out ay any time.

(2) Inspections of financial futures dealers

❑ **Financial futures dealers**

In principle, inspections were to be conducted in conjunction with those of the Financial Inspection

Department. If necessary, said inspections were to be conducted at any time.

III. Status of Inspections

1. Inspection status

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

(1) Inspections of securities companies

In SESC year 1994, the SESC and regional finance bureaus commenced inspections of 85 securities companies and 11 financial institutions licensed to provide securities services.

Of this total, the SESC commenced inspections of 10 domestic securities companies, eight branches of six foreign securities companies, and one financial institution licensed to provide securities services. Regional finance bureaus commenced inspections of 69 domestic securities companies and 10 financial institutions.

Regarding inspections commenced in SESC year 1994, by SESC year-end (June 30, 1995), Notifications of Conclusion had been presented to and inspections had been completed on 43 domestic securities companies, three branches of three foreign securities companies, and 10 financial institutions (Table 2). In addition, inspections commenced in SESC year 1993 that had not been completed by June 30, 1994, including inspections of 18 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 instructed the JSDA to enact disciplinary actions, such as suspensions of operations as registered sales representatives, against five companies for grave violations of laws and regulations by their officers and employees (detailed in Chapter 2).

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

(2) Inspections of financial futures dealers

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

Table 2: **Inspection Status**

	SESC Year 1992	SESC Year 1993	SESC Year 1994	Total
Securities companies (total)	84 (69)	87 (70)	85 (69)	256
Domestic	78 (69)	79 (70)	79 (69)	236
Foreign	6	8	6	20
Financial institutions licensed to provide securities services	11 (8)	13 (10)	11 (10)	35

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

2. *Total personnel per inspection*

This SESC year, 108 man-days were assigned per inspection (on-site basis) for domestic securities companies, 47 man-days for foreign securities companies, and 15 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	SESC Year 1994
Securities companies			
Domestic	103	111	108
Foreign	60	43	47
Financial institutions licensed to provide securities services	16	20	15

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 (including those described in Chapter 2).

(1) Concerning the observance of transaction rules, the following problems were found in some securities companies, including the acceptance of discretionary trading account transaction contracts.

① Acceptance of discretionary trading account transaction contracts	legal violation
② Securities transactions for speculative profit	legal violation
③ Negotiated transactions between registered sales representatives and customers	violation of self-regulatory rules
④ Lending and borrowing names for securities transactions	violation of self-regulatory rules
⑤ Accepting orders for transactions made under assumed names	violation of self-regulatory rules
⑥ Lending securities to and borrowing them from customers	violation of self-regulatory rules

(2) Concerning sales practices, the following problems were found in some securities companies, including solicitation ignoring the will of customers during the active marketing of foreign stocks and convertible bonds.

① Revolving transactions to cut short-term losses on foreign stocks, convertible bonds, etc., which were promoted by sales representatives and ignored the will of investors.

② In transactions between customers and securities companies to realize unrealized gains, adjusting losses and gains from said transactions through other transactions with the same customer.

(3) Generally speaking, internal control systems in most companies are improving. However, in some securities companies such systems are not functioning well because of insufficient awareness regarding compliance with laws and regulations, as well as a lack of knowledge about the systems. The following problems have been acknowledged:

① Insufficient internal control systems;
② Insufficient internal inspection systems;
③ Late receipt of "Confirmation of Over-the-Counter Transaction" reports and other documents; and
④ Occurrence of securities incidents and problems with customers.

Reference

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. Negotiated transactions between registered sales representatives and customers

A sales representative of Securities Company A received a request from a customer to cancel an investment trust contract. However, because the closed period was not sufficiently explained at the time of the offering the sales representative purchased the investment trust with his own funds.

2. Lending and borrowing names for securities transactions

A sales representative of Securities Company B, to minimize the rollover ratio from existing investment trusts, let a customer use his friends' accounts for purchases. Also, because the transactions of a sales representative's relatives cannot be counted in the representative's sales results, the sales representative of Securities Company B let a relative use a customer account for purchases.

3. Accepting orders for transactions made under assumed names

A sales representative of Securities Company C accepted orders from customers for the purchase of securities at their offering without confirming each applicant, despite the fact that he suspected the customers were using numerous assumed names to increase their chances of winning purchase rights through the lottery system.

4. Lending securities to and borrowing them from customers

A sales representative of Securities Company D, to reverse an insufficiency of the amount of deposited margin required for a margin transaction with a customer and to avoid a deposit insufficiency at the new margin position, lent the customer securities borrowed from another customer with consent for usage as collateral.

○ Cases concerning sales practices

1. Revolving transactions to cut short-term losses promoted by sales representatives ignoring the will of investors (1)

Securities Company E, because fees and deposited assets fell in accordance with sluggishness in the stock market, actively marketed foreign stocks, foreign investment trusts and convertible bonds. However, from the contents of customer transactions many cases were acknowledged of repeated loss-cutting transactions for the same kinds of products in a short period. Also acknowledged among these transactions were many examples of excessive solicitation in which product characteristics and the will of investors were ignored.

2. Revolving transactions to cut short-term losses promoted by sales representatives ignoring the will of investors (2)

At numerous branches of Securities Company F, specific stocks were actively promoted. However, from the contents of customer transactions many cases were acknowledged of repeated transactions of the same stocks in a short period, including day transactions (the selling of stocks on the same day they are purchased). Also acknowledged among these transactions were many examples of excessive solicitation by sales representatives in which the will of investors was ignored.

In addition, at the same securities company short-term revolving transactions promoted by sales representatives for other stocks and convertible bonds were acknowledged in which the will of investors was ignored. In some cases, despite repeated warnings from the control division in the head office such behavior regarding transactions did not improve.

3. In transactions between customers and securities companies to realize unrealized gains, adjusting the losses and gains of securities companies resulting from said transactions through other transactions with the same customer

Securities Company G received a request from a corporate customer for transactions to realize unrealized gains on some stocks, which were executed in the stock exchange. Regarding one of these stocks, the same price as that of the original transaction (sale by the customer to Securities Company G) could not be achieved for the return transaction (sale of the same stock by Securities Company G to the customer). To adjust for the loss it incurred through this transaction, Securities Company G added and subtracted amounts equal to its loss to the prices of other stocks, implementing return transactions at prices different from market prices.

○ Internal control systems

1. Occurrence of securities incidents and problems with customers owing to insufficient internal control systems

Securities Company H uses the so-called "attention system," under which its headquarters control division notifies branches of supervised accounts tagged because of frequently repeated transactions and the incurring of losses. However, convertible bonds and foreign bonds that the company was actively promoting were not included in subject securities products for the attention system. In addition, even in the case of tagged accounts control was insufficient. As a result, the transactions of these customers did not improve, and securities incidents and problems with customers were acknowledged.

2. Occurrence of securities incidents and problems with customers owing to insufficient internal inspection systems

At Securities Company I, cases occurred of perfunctory improvement reports from branch managers for problems discovered through internal inspections by the inspection division. Cases were also seen in which no disciplinary actions were taken for the lack of improvement. As a result, the transactions of relevant customers did not improve, and securities incidents and problems with customers were acknowledged.

3. Late receipt of "Confirmation of Over-the-Counter Transaction" reports and other documents

Securities Company J, because the domestic market for listed stocks was sluggish, actively promoted over-the-counter and foreign stocks. However, in the process of this promotion cases were acknowledged at many branches of late collection of "Confirmation of Over-the-Counter Transaction" reports and "Agreement to Establish an Account for Foreign Securities Transactions" forms, which securities companies are required to receive at the commencement of transactions as a means to deepen customers' understanding of their responsibilities.

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. However, no specific problems were acknowledged this SESC year.

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.

I. Outline

1. *Significance of market surveillance*

The objective of market surveillance is to ensure the fairness of securities transactions and the protection of investors. The SESC ensures these objectives by collecting detailed reports about securities transactions and necessary materials for daily market surveillance from securities companies and SROs. These activities are carried out under the authority delegated by the Minister of Finance as prescribed in the SEL, LFSF and FFTL.

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

Note ①: Information in parentheses indicates provisions for delegation of market surveillance authority.

Note ②: As with the SESC's inspection authority, the authority to collect reports and materials is entrusted to directors-general of regional finance bureaus. (However, if necessary the SESC may exercise said authority on its own.)

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 based on the authority to collect reports and related materials.

3. Emphasis of market surveillance

Market surveillance is conducted paying attention to the following points:

① Stocks experiencing sharp price rises or drops

② Stock price movements before and after corporate accounting periods

③ Stock price movements of convertible bond issues before, on and after conversion price calculation dates (during financing)

④ Stock price movements before and after cross-transactions

⑤ Stocks for which information appeared that significantly influenced price formation

⑥ Information provided by sources in the general public

The following points are emphasized in market surveillance.

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. Status of Market Surveillance

1. Number of cases

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

In SESC year 1994, cases of detailed market surveillance were as follows:

Related to manipulation:	111 cases
Related to insider trading:	62 cases
Related to other items:	22 cases

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

Conducted by the SESC: 107 cases

Conducted by regional finance bureaus: 88 cases

Table 4: Results of Market Surveillance

(Unit: cases)

Category	SESC Year 1992	SESC Year 1993	SESC Year 1994
Related to manipulation	154	162	111
Related to insider trading	12	50	62
Others	4	5	22
Total	170	217	195
Surveillance by regional finance bureaus	95	115	88

2. Summary of surveillance results

Surveillance of market manipulation centered on cases in which, despite the overall sluggishness of the market, transaction volume centered on certain stocks having particular material news, the prices of which rose sharply; cases in which transactions were seen on the above-mentioned stocks by specific investors; and cases in which stock prices fluctuated widely at the end of the fiscal year. Surveillance of insider trading centered on cases in which the judgment of investors was significantly influenced, such as cases in which stock prices fluctuated widely following announcements of result forecast revisions, the issuing of new shares and merger activities, by the issuing companies.

Although SESC surveillance has found no problems in most cases, regular market surveillance through these activities functions as both a direct and indirect deterrent to unfair transactions.

Surveillance cases during SESC year 1994 were as follows.

Surveillance related to manipulation

(1) As a result of irregular purchases by a specific investor thought to be made for the purpose of raising the price of a stock and cross transactions by said investor, for a certain period the price of said stock rose steadily.

(2) Company B, which was a major shareholder of Company A, and related parties purchased stocks on a continuing basis, and fixed-price conditions were seen for said stocks.

(3) During the period in which the stock price of Company C rose sharply, large-volume purchases by other companies of which the same person was the de facto chief executive were acknowledged.

Surveillance related to insider trading

(1) Stock-issuing Company D announced a capital increase through a third-party allocation. However, prior to said announcement purchases of Company D's stocks by Company E, which subscribed the capital increase allocation, and officers of Company E, were acknowledged.

(2) Stock-issuing Company F announced a downward revision in its results forecast, but, prior to said announcement, sales of Company F's stocks by officers of the company, who received a report of the results forecast revision, were acknowledged.

(3) Stock-issuing Company G announced a capital increase allocation of Company H and that Company H would become a subsidiary of Company G. However, prior to said announcement, purchases of Company G's stocks by officers of the company were acknowledged.

(4) Stock-issuing Company I announced that it had petitioned for the commencement of reorganization procedures, but, prior to said announcement, sales of Company I's stocks by employees and business associates of the company were acknowledged.

Surveillance related to other items

(1) On many occasions, Securities Company J implemented sales and repurchases of stocks through cross

transactions with Real Estate Company K, an affiliate of Securities Company J, for the purpose of realizing unrealized gains. However, in the return transactions repurchases at prices continually higher than the selling prices were acknowledged.

(2) On the basis of a research report related to the stock of Company M by Economic Research Center L, which is an affiliate of Company N, the stock price of Company M rose in accordance with a large volume of transactions by Company N.