

Message from the Chairman

I am very pleased to present this summary of the activities of the Securities and Exchange Surveillance Commission (SESC).

In accordance with the law, the SESC describes its activities in an annual report. This English-language publication is intended to familiarize readers with the SESC by outlining its activities, including its organization and the background of its establishment. It is based on the Japanese-language annual report for the period from July 1, 1995, to June 30, 1996 (SESC year 1995), which was released in October 1996.

The SESC was established on July 20, 1992, as an independent agency charged with ensuring fair securities and financial futures transactions, thus maintaining the confidence of investors in these markets.

The SESC is an organization based on a council system comprising a chairperson and two commissioners. Commission members are appointed by the Minister of Finance with the approval of the Diet, but the chairperson and commissioners implement their authority independently. In addition to an Executive Bureau, which carries out the SESC's regular operating



Chairman: Toshihiro Mizuhara

functions, the organization includes regional offices that primarily conduct inspections of local securities companies.

With this organization, the SESC implements investigations of criminal cases of violating the fairness of transactions, inspections of securities companies and other institutions, and regular surveillance of securities markets. Through these activities, the SESC aims to ensure market fairness and transparency, and con-

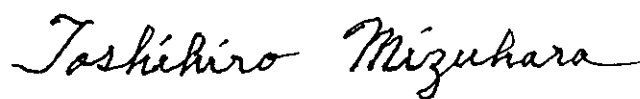
tribute to the sound functioning of securities markets in Japan.

Specifically, based on provisions in the Securities and Exchange Law (SEL) and related legislation, the SESC has three main functions: (1) investigations of criminal offenses, which comprise non-compulsory investigations (inquiring, inspecting and provisional holding), and compulsory investigations (visiting, searching and seizing with legal warrants); (2) on-site inspections of securities companies to supervise compliance with laws and regulations on the maintenance of transaction fairness; and (3) daily market surveillance of securities transactions based on information and reports from securities companies and self-regulatory organizations (SROs).

In addition, in accordance with the globalization of securities transactions and in view of the growing importance of international cooperation and cross-border law enforcement collaboration to ensure fair-

ness in securities markets in Japan, in October 1993 the SESC joined the International Organization of Securities Commissions (IOSCO) as an associate member. Also, the SESC actively participates in bilateral and multilateral meetings of foreign regulatory authorities together with the Securities Bureau of the Ministry of Finance. Through these activities, we will continue to actively exchange opinions and information.

It is my sincere hope that this report will facilitate public understanding of the SESC and the importance of its activities in securities markets.



Toshihiro Mizuhara

Chairman

Securities and Exchange Surveillance Commission

November 1996

The SESC's activities in SESC year 1995 (July 1, 1995, to June 30, 1996) are detailed throughout this report. Following are summaries of investigations of criminal offenses, inspections and market surveillance activities conducted during this year.

1. Investigations of criminal offenses

With respect to investigations of criminal offenses, one compulsory investigation was conducted on suspicion of "circulating rumors" in relation to an article in the monthly magazine *Gamble Taitei*. In addition, one accusation of criminal offense, related to loss compensation, was made to the public prosecutor's office under the Securities and Exchange Law (SEL).

As a result, since its establishment investigations by the SESC have resulted in a total of six accusations: one on the charge of market manipulation, one on the charge of submitting a securities report containing falsified information, two on charges of insider trading, one on the charge of circulating rumors, and one on the charge of loss compensation.

2. Inspections

Securities companies, financial institutions licensed to provide securities services, and other related organizations, such as self-regulatory organizations (SROs), are subject to SESC inspections. During SESC year 1995, inspections were commenced at 84 domestic and two foreign securities companies, and 10 financial institutions.

As a result, since its establishment the SESC has conducted a total of 320 inspections of domestic securities companies. This means that the SESC has undertaken inspections of all domestic securities companies, and has begun a second round of inspections. In addition, since its establishment the SESC has conducted inspections of 22 foreign securities companies and 45 financial institutions.

In conducting inspections, the SESC prioritizes such matters as compliance with transaction rules, sales practices and internal control systems.

Based on its inspections, the SESC found the following facts: ① failure to comply with transaction laws,

regulations and self-regulatory rules regarding bucketing (see page 9); ② improper investment practices related to aggressive solicitation for sales of convertible bonds and foreign securities that disregard the attributes of customers; and ③ deficiencies in internal control systems and insufficient awareness among corporate directors regarding failure to comply with transaction laws and regulations.

The SESC sent recommendations to the Minister of Finance to take appropriate measures against two securities companies and nine directors and/or employees, based on grave legal and regulatory violations related to the above points.

3. Market surveillance

In SESC year 1995, the SESC conducted surveillance activities in 215 cases, including 158 of suspected manipulation, 54 of insider trading and three related to other matters. Since its establishment, the SESC has carried out surveillance activities in 797 cases, including 585 of suspected manipulation, 178 of insider trading and 34 related to other matters.

In conducting its market surveillance activities, the SESC places great importance on how securities companies take part in specific securities transactions and whether said securities transactions violate the SEL and its regulations, and whether SROs are properly performing their functions to monitor market activities.

In the year under review, the SESC stepped up the number of surveillance cases, due to numerous instances of sudden stock price rises in the wake of general market recovery. Cases of surveillance related to manipulation included issues for which prices surged suddenly and trading was conspicuous by specific agents, as well as on stocks that fluctuated significantly at the end of the fiscal term. Regarding insider trading, the issuing of new stocks, amendments of expected business results by the issuing company, and damages caused by business operations, stock splits and mergers announced to cause significant fluctuations in stock prices became the center of surveillance attention as the decisions of investors were possibly influenced considerably.

I. Outline

1. *Significance of and authority for investigations of criminal offenses*

The authority for investigation of criminal offenses was created especially for the SESC at its establishment. With this authority, the SESC traces illegal actions violating laws and regulations, then calls for criminal prosecution by making formal accusations. This authority was created to ensure market fairness and soundness, as well as to protect investors.

Investigations of criminal offenses are carried out by SESC staff by their particular authority under the SEL, the Law on Foreign Securities Firms (LFSF) and the Financial Futures Trading Law (FFTL), while inspections against securities companies and other related financial institutions are conducted under the authority delegated by the Minister of Finance. The SESC's authority is not limited to securities companies, but includes all parties involved in securities transactions, including investors themselves.

Specifically, the SESC may conduct noncompulsory investigations of criminal offenses (SEL Article 210, LFSF Article 38(2), FFTL Article 106), including making inquiries of suspects and related parties, inspection of materials in the possession of or left behind by

suspects, and the confiscation of materials supplied or left behind by suspects. The SESC may also conduct compulsory investigations with legal warrants (SEL Article 211, LFSF Article 38(2), FFTL Article 107). Such investigations include visiting and searching the premises of suspects and seizing related evidence.

2. *Scope of criminal offenses*

The scope of criminal offenses covers those that violate securities transaction fairness prescribed in the relevant Cabinet Order (SEL Enforcement Order Article 38, LFSF Enforcement Order Article 17, FFTL Enforcement Order Article 12). These mainly involve submission of securities reports with falsified information, providing loss compensation and guarantees on securities transactions, and committing market manipulation and insider trading.

The results of investigations are reported to the SESC by the investigating SESC staff (SEL Article 223, LFSF Article 38(2), FFTL Article 119). When convinced of a suspect's guilt, the SESC sends an accusation and delivers evidence seized during its investigations as well as lists of said evidence to public prosecutors' offices (SEL Article 226, LFSF Article 38(2), FFTL Article 122).

II. Status of Accusations of Criminal Offenses

1. Investigations of criminal offenses

During SESC year 1995, a compulsory investigation—including visiting and searching the premises of suspects and related parties, and the seizure of evidence—was conducted in March 1996 based on “circulation of rumors” related to an article in the monthly magazine *Gamble Taitai* while conducting other necessary investigations according to the authority described above.

2. Accusations

Based on investigation results, the SESC sent an accusation to a public prosecutor's office concerning a possible SEL violation related to loss compensation.

This case is summarized below.

(Case)

On December 22, 1995, the SESC, concerning suspicion of loss compensation, sent accusations against suspects (one suspect securities company and eight directors and three customers thereof) to the Tokyo District Public Prosecutor's Office for offenses under the SEL (Article 50(3)1-2 “Prohibiting of loss compensation”).

Outline of facts

(1) Suspects A (securities company) and B (directors of same company) and seven other suspects, with no exceptional legal reason, compensated for customers' losses incurred through securities trading and other transactions. Furthermore, Suspect A, through operation of its on-line terminals, undertook transactions for its own account disguised as trading at the behest of specific customers, in order to supplement customers' property gains. The alleged violations were carried out a total of more than 70 times, on behalf of more than 10 customers, between February 1993 and September 1994, resulting in property gains of approximately ¥67 million.

(2) Suspect C and two other suspects (customers of Suspect A) opened accounts at a certain branch of Suspect A to engage in securities trading and other transactions and, with no exceptional legal reason, contacted Suspects D and E (directors of Suspect A) to request partial compensation for losses incurred through legitimate securities trading. Through the method described in (1) above, the said suspect customers received property gains of approximately ¥20 million between March 1993 and June 1994 in a total of more than 10 alleged violations.

Note: On February 14, 1996, one suspect company and five suspect individuals were charged with acts of loss compensation in this case, and on February 19 four individual

suspects received summary orders. As of June 30, 1996, cases against the suspect company and one individual suspect were pending trial.

I. Outline

According to the results of inspections and investigations of criminal offenses, as deemed necessary the SESC can send recommendations to the Minister of Finance for disciplinary actions or other appropriate measures (hereafter referred to as “administrative disciplinary actions”) to ensure securities transaction fairness (Ministry of Finance Establishment Law (MFEL) Article 19(1)). Following are the major contents of these recommendations classified by type:

- ① For administrative disciplinary actions against securities companies for legal violations;
- ② For administrative disciplinary actions against SROs, such as securities dealers associations and stock exchanges, that neglect to execute their authority and take necessary actions in cases of violations by securities companies and financial institutions licensed to provide securities services; and
- ③ Recommendations that the Minister of Finance instruct SROs to take appropriate measures when said SROs neglect to execute their authority and take necessary actions in cases of violations by securities companies and financial institutions.

The Minister of Finance must respect recommendations made by the SESC, under the MFEL Article 19(2). The SESC can also request the Minister of Finance to report on actions taken based on its recommendations, under MFEL Article 19(3).

After receiving recommendations for administrative disciplinary actions, and based on the results of inspections made by the SESC, the Minister of Finance holds hearings with the parties involved and, when deemed valid, takes appropriate actions, such as suspending the operations of the accused company.

Matters concerning the registration of sales representatives, including administrative disciplinary actions against sales representatives, have been delegated by the Minister of Finance to the Japan Securities Dealers Association (JSDA). This association takes administrative disciplinary actions in cases of illegal sales activities by securities companies. When deemed valid, the JSDA takes such measures as revoking sales representative registrations and suspending operations as sales representatives. These measures are taken after hearings by the JSDA, which follow notifications by the Minister of Finance and SESC inspection results.

II. Status of Recommendations and Measures Taken

In the year under review, the SESC sent 10 recommendations to the Minister of Finance for administrative disciplinary actions against securities companies and their directors and employees for grave legal violations found during inspections and investigations of criminal offenses. These cases are detailed later in this report.

These 10 cases include nine in which the SESC sent recommendations for administrative disciplinary actions based on the results of inspections of securities companies, and one based on the results of investigations of criminal offenses.

In response to the 10 recommendations, administrative disciplinary actions were taken against three companies and 23 directors and employees thereof. Related violations of legal regulations, by act and content of wrongdoing, and administrative disciplinary actions taken by the Minister of Finance, are as follows:

Note: In cases where inspection of a single securities company or investigation of a single criminal offense reveals multiple violations of the law, only one recommendation is made. Therefore, the number of recommendations does not reflect the number of legal violations.

(1) Companies and directors and employees thereof in violation of laws and regulations

① Counter bucketing and bucketing

(Violation of SEL Articles 47 and 129(1))

Securities Company J mistakenly acquired stocks in multiple companies over and above those for which it was contracted by customers. Without undertaking measures required by company regulations, on the days the mistakes came to light Company J solicited customers to purchase the said stocks. When the customers thus placed orders for the stocks, Company J directly transferred listed stocks from its own account instead of purchasing via stock exchanges, and also directly transferred specified unlisted stocks from its own account, reporting these transactions as original orders from customers (June 1994 to July 1995).

Administrative disciplinary action

Against the company: Suspension of accepting orders for stock trading at Branch B (one day).

Note: Under SEL Article 47, it is illegal for a securities company to act as a principal and broker for the same securities trading transaction, including a transaction involving unlisted securities, made on receipt of order from a customer. Furthermore, under SEL Article 129 it is illegal,

for a securities company that has received an order for securities trading on a securities market to become the other party to such securities trading for its own account, and for a securities company not to purchase via a securities exchange or member thereof. Violations of SEL Article 47 are commonly referred to as "counter bucketing" and violations of Article 129 as "bucketing."

② Purchase of securities for own account by general underwriter during stabilization period

(Violation of Ministerial Ordinance 2(6), based on SEL Article 50(1)6, which applies to LFSF Article 21(4))

Branch A of Securities Company D purchased and sold stocks and convertible bonds of 38 companies in 99 separate transactions (May 1989 to February 1995) during the stabilization period for its own account, although such transactions did not come under "stable transactions" or "correction of mistaken transactions" as recognized by law.

Administrative disciplinary action

Against the company: Suspension of stock trading for own account at the Arbitrage Department of Branch A (two days).

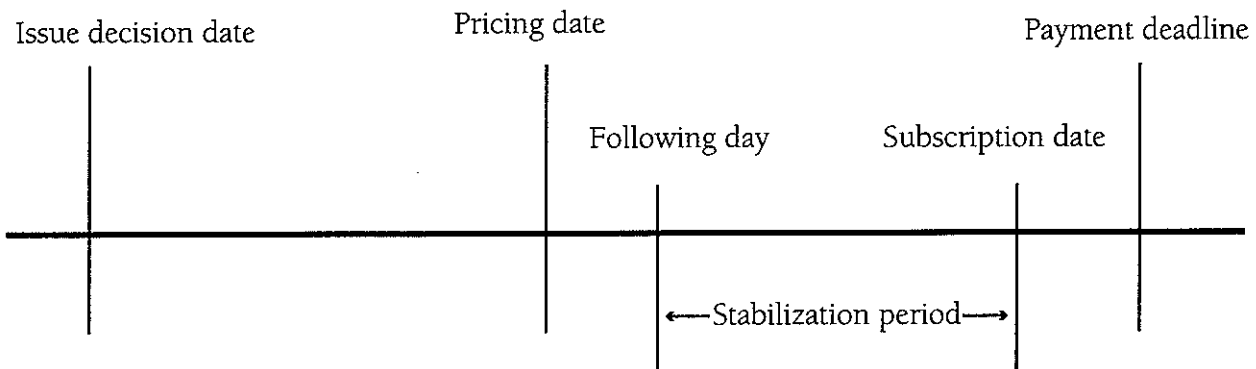
Reference: Purchase of securities by general underwriter for own account during stabilization period

Although general underwriters are allowed to engage in stable transactions for their own accounts (see Note 1), in order to comply with regulations related to stable transactions, a ministerial ordinance provides that unless such stable transactions be undertaken during the stabilization period (see Note 2) according to procedures specified under the SEL, or transactions are made to correct order-related errors, trading for one's own account is prohibited (Ministerial Ordinance 2(6)).

Note 1: Stabilization transactions

In principle, it is illegal to act alone or jointly with others to effect a series of trading in a security on a securities exchange, or place or accept orders for such trading, with the aim of pegging, fixing or stabilizing the market price of such security, because it is recognized as market manipulation. However, since it may be difficult to purchase or sell the security due to temporary price fluctuations, transactions during the stabilization period by underwriters are allowed, to the extent that such transactions are effected in order to guarantee smooth purchase or sale, and that such transactions comply with SEL Articles 20 through 26 (SEL Article 159(3)).

Note 2 Table: Stabilization period



③ Supplementing customer profits through property gains, in order to effect loss compensation

(Violations of SEL Article 50(3)1-3)

Securities Company G, through actions by 14 directors and employees thereof, partially compensated for customers' losses incurred through securities trading and, in order to supplement profits of said customers, undertook stock trading for its own account disguised as transactions effected through orders of said customers, thus producing property gains (May 1992 to November 1994).

Administrative disciplinary action

Against the company: Suspension of stock trading for own account (eight weeks), as well as:

- Suspension of accepting orders for stock trading at Branch A (eight weeks);
- Suspension of accepting orders for stock trading at

Branch D (two weeks);

- Suspension of accepting orders for stock trading at Branch B, Branch C and Branch E, as well as at Securities Company G's sales and institutional business divisions (one week).

Against directors and employees:

- Cancellation of operations as registered sales representatives (seven persons);
- Suspension of operations as registered sales representatives (six persons; six months).

Notes:

1. Among the seven persons whose operations as sales representatives were canceled, one person was also subject to disciplinary action for a violation related to conclusion of discretionary trading account transaction contracts, described later in this chapter.
2. Among the 14 persons named in the SESC recommenda-

tions, one person, who was not a registered sales representative, was subject to disciplinary action by the JSDA for improper conduct.

(2) Directors and employees in violation of laws and regulations

① Inducing customers by offering definitive predictions

(Violation of SEL Article 50(1)1)

A commission sales representative of Securities Company J received a request from a large customer to terminate transactions due to accumulated losses on margin transactions and, concerned about the effect of such termination on his commission income, made definitive predictions to said customer that the price of certain securities “will definitely rise,” thus inducing said customer to make further purchases (September to November 1991).

Administrative disciplinary action

Against the sales representative: Suspension of operations as registered sales representative (pending).

② Conclusion of discretionary trading account transaction contracts

(Violation of SEL Article 50(1)3)

(a) A managing director of Securities Company B, who was also division manager of the product division, had difficulty contacting a customer due to the customer’s business obligations. He therefore agreed on multiple occasions with the customer to accept orders for securities trading transactions, including margin transactions (January 1992 to February 1994). The nature of the agreement gave the managing director discretionary powers to decide, without customer consent, all aspects of share trading transactions—whether to purchase or sell, shares issued, number of shares and prices—or part thereof. In this case, the managing director acted on his own judgment based on a discretionary trading account transaction contract. (Number of transactions approximately 680; number of stocks traded approximately 1.4 million.)

Furthermore, another managing director of Securities Company B, who was also sales manager at the Tokyo sales office, had difficulty contacting a customer due to the customer’s business obligations. He therefore agreed on multiple occasions with the customer to accept orders for securities trading transactions, including margin transactions (February 1993 to June 1996). The nature of the agreement gave the managing director discretionary powers to decide, without customer consent, all aspects of share trading transactions—whether to purchase or sell, shares issued, number

of shares and prices—or part thereof. In this case, the managing director acted on his own judgment based on a discretionary trading account transaction contract. (Number of transactions approximately 150; number of stocks traded approximately 700,000.)

Administrative disciplinary action

Against managing director/product division manager: Suspension of operations as registered sales representative (three months).

Against managing director/Tokyo sales office manager: Suspension of operations as registered sales representative (two weeks).

(b) A sales section chief of Branch A of Securities Company C had difficulty in contacting a customer due to the customer's business obligations. He therefore agreed with the customer to accept orders for securities trading transactions (March 1993 to April 1995). The nature of the agreement gave the section chief discretionary powers to decide, with customer consent, whether to purchase or sell, shares issued and number of shares, but without customer consent on share prices. In this case, the section chief acted on his own judgment based on a discretionary trading account transaction contract. (Number of transactions approximately 500; number of stocks traded approximately

900,000.)

Administrative disciplinary action

Against the section chief: Suspension of operations as registered sales representative (one month).

(c) A director and branch manager of Branch A of Securities Company E, for the purpose of increasing a certain customer's profits and increasing his sales results agreed with said customer to accept orders for stock and bond trading transactions, including margin transactions (January 1992 to February 1995). The nature of the agreement gave the director discretionary powers to decide, without customer consent, whether to purchase or sell, shares issued, number of shares and share prices. In this case, the director acted on his own judgment based on a discretionary trading account transaction contract. (Number of transactions approximately 800; number of stocks traded approximately 2 million.)

Administrative disciplinary action

Against the director/branch manager: Suspension of operations as registered sales representative (four months).

(d) The deputy manager of the sales division of Branch

A of Securities Company F had difficulty in contacting a customer due to the customer's business obligations. He therefore agreed with the customer to accept orders for margin transactions (March 1993 to January 1995). The nature of the agreement gave the deputy manager discretionary powers to decide, with customer consent, whether to purchase or sell and shares issued, but without customer consent on number of shares and share prices. In this case, the deputy manager acted on his own judgment based on a discretionary trading account transaction contract. (Number of transactions approximately 450; number of stocks traded approximately 2.7 million.)

Administrative disciplinary action

Against the deputy manager: Suspension of operations as registered sales representative (one month).

(e) A managing director of Securities Company G agreed with multiple customers to accept orders for stock trading and other transactions (August 1992 to June 1994). The nature of the agreements gave the managing director discretionary powers to decide, without customers' consent, whether to purchase or sell, shares issued, number of shares and share prices. In these cases, the managing director acted on his own

judgment based on discretionary trading account transaction contracts.

Administrative disciplinary action

Against the managing director: Cancellation of operations as registered sales representative.

Note: A violation by the same managing director in the loss compensation case against Securities Company G (described in (1)(3) earlier), was taken into account in determining disciplinary action.

③ Entering into securities transactions agreements in the knowledge that such transactions will have manipulative market effect

(Violations of ministerial ordinance, according to SEL Article 50(1))

The section chief of the institutional division of Securities Company H, on behalf of a specific customer, made purchases of a specific stock by market orders and high limit orders, driving up the price of said stock to a predetermined level, then executed trading of said stock at the predetermined price through third parties. In this case, the section chief continued to receive and execute transaction orders despite knowing that his actions to drive up the price of said stock were manipulative and would not reflect market realities.

Administrative disciplinary action

Against the section chief: Suspension of operations as registered sales representative (two weeks).

④ Securities transactions for the purpose of pursuing speculative profits

(Violations of ministerial ordinances, according to pre-amended SEL Article 50(1)5, and ministerial ordinances under SEL Article 50(1)6)

(a) A commission sales representative in Sales Division II of Securities Company A, for the purpose of compensating for a decline in commission income owing to termination of orders by a large customer due to sluggish market conditions, requested a customer to open a margin transaction account and, using this account, on multiple occasions implemented stock trading through margin transactions based on his own calculations (July 1991 to April 1995). (Number of transactions approximately 500; number of stocks traded approximately 4 million.)

Administrative disciplinary action

Against the sales representative: Suspension of operations as registered sales representative (two months).

(b) The representative branch manager of Branch A of Securities Company I, for the purpose of improving his sales results and pursuing personal profits, using his friend's account on multiple occasions implemented stock trading through margin transactions based on his own calculations (July 1994 to January 1995). (Number of transactions approximately 150; number of stocks traded approximately 200,000.)

Administrative disciplinary action

Against the representative branch manager: Suspension of operations as registered sales representative (two weeks).

Table 1: SESC Recommendations

(Unit: cases)

Category	SESC Year 1992	SESC Year 1993	SESC Year 1994	SESC Year 1995
Number of recommendations	2	13	5	10
Based on inspections	2	12	5	9
Based on SESC inspections	1	7	—	2
Based on regional finance bureau inspections	1	5	5	7
Based on investigations of criminal offenses	—	1	—	1