Proposals

I. Outline

The SESC can send proposals to the Minister of Finance as necessary for maintaining securities transaction fairness based on the results of inspections and investigations of criminal offenses (MFEL Article 20).

In its proposals, the SESC states its view about laws, regulations and self-regulatory rules, after analyzing facts found through inspections and investigations of criminal offenses. SESC proposals are to be reflected in the policy planning of the Ministry of Finance and SROs. Proposals by the SESC are treated as important materials for carrying out policies of the Ministry of Finance.

II. Status of Proposals

In the year under review, the SESC through its inspections found no problems requiring the submission of proposals.

I. Outline

1. Significance of inspections and parties inspected

The SESC conducts on-site inspections of securities companies and related organizations, such as SROs, 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 executing necessary measures and policies as regards securities companies.

The SESC's authority to inspect and seize reports and materials is entrusted to directors-general of regional finance bureaus. (If necessary, however, the SESC may exercise said authority.)

Specifically, the following institutions are subject to SESC inspection:

Securities companies and other organizations, such as SROs, 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: 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 (SEL Enforcement Order Articles 16, 17(5), 18(2) and 19(2); LFSF Enforcement Order Article 14; and FFTL Enforcement Order Articles 3, 4, 7 and 10). For example, the SESC is authorized to conduct inspections related to violations of laws and regulations by securities companies and their directors and employees (including discretionary trading account transactions, solicitation with definitive predictions and solicitation with promises of special profit), as well as related to such violations as loss compensation and guarantees, market manipulation and insider trading (refer to supplementary materials 1-3).

II. Basic Policy and Plan of Inspections

Inspections are carried out on a SESC-year basis, from July 1 to the following June 30.

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

Basic policies for inspections determine priority inspection topics and other topics that form the basis of inspections. Basic plans for inspections determine such matters 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 1995 (year under review) were decided on June 27, 1995, as follows:

Basic policy and plan of inspections in SESC year 1995

1. Basic policy of inspections

While financial and capital markets face ongoing deregulation and globalization, resulting in increasingly complex and diversified securities activities, concerns about worsening corporate results due to the rapid rise in the yen have caused stock markets to stagnate, leading to a continuing difficult environment surrounding securities companies. At the same time, relaxation of various regulations, aimed at stimulating securities markets, has created the potential for securities companies to expand their marketing activities.

Cases were acknowledged in some companies of investment solicitation and inappropriate transactions ignoring the will of investors, as well as securities companies and their directors and employees committing violations of laws and regulations. Also, while overall improvement regarding internal control systems has been noted, some cases of insufficient awareness of regulations and/or internal control systems were acknowledged, meaning that not all such systems are functioning sufficiently.

Given this situation, the priorities for inspecting securities and related companies for the year under review 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 compliance with market rules from various points of view.

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 and 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**	**81**
❑ **Foreign securities companies**	**2**

Notes:

1. In addition to the above domestic securities companies, 18 individual branch offices of securities companies were to be inspected.

2. Specific targets of inspection are selected upon fully considering such matters as time elapsed since previous inspection and results of previous inspection, and attention was also paid to continual smooth implementation of inspections.

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

4. 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 at 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 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*

In the year under review, the SESC and regional finance bureaus commenced inspections of 86 securities companies, and 10 financial institutions licensed to provide securities services.

Of this total, the SESC commenced inspections of nine domestic securities companies and four branches of two foreign securities companies. Regional finance bureaus commenced inspections of 75 domestic securities companies and 10 financial institutions licensed to provide securities services.

Regarding inspections commenced during the year under review, by SESC year-end (June 30, 1996) Notifications of Conclusion had been presented to and inspections had been completed on 60 domestic securities companies and nine financial institutions (Table 1). In addition, inspections commenced in SESC year 1994 that had not been completed by June 30, 1995, including inspections of 36 domestic securities companies, five branches of three foreign securities companies, and one financial institution licensed to provide securities services, were completed during the year under review.

Following SESC recommendations based on these inspections, the Minister of Finance enacted administrative disciplinary actions, such as suspension of operations, against two companies and nine directors and employees for grave violations of laws and regulations (detailed on page 8).

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*

In SESC year 1995, inspections of financial futures dealers were carried out in conjunction with securities inspections.

Table 2: **Inspection Status**

Category	SESC Year 1992	SESC Year 1993	SESC Year 1994	SESC Year 1995	Total
Securities companies	84(69)	87(70)	85(69)	86(75)	342
Domestic	78(69)	79(70)	79(69)	84(75)	320
Foreign	6	8	6	2	22
Financial institutions licensed to provide securities services	11(8)	13(10)	11(10)	10(10)	45

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*

In SESC year 1995, 107 man-days were assigned per inspection (on-site basis) for domestic securities companies, 105 man-days for foreign securities companies, and 14 man-days for financial institutions licensed to provide securities services (see Table 3).

Table 3: **Total Personnel per Inspection**

(Unit: man-days/inspection)

Category	SESC Year 1992	SESC Year 1993	SESC Year 1994	SESC Year 1995
Securities companies				
Domestic	103	111	108	107
Foreign	60	43	47	105
Financial institutions licensed to provide securities services	16	20	15	14

Note: Figures for man-days are calculated according to an on-site basis.

IV. Results of Securities Company Inspections

1. Problems acknowledged through inspections

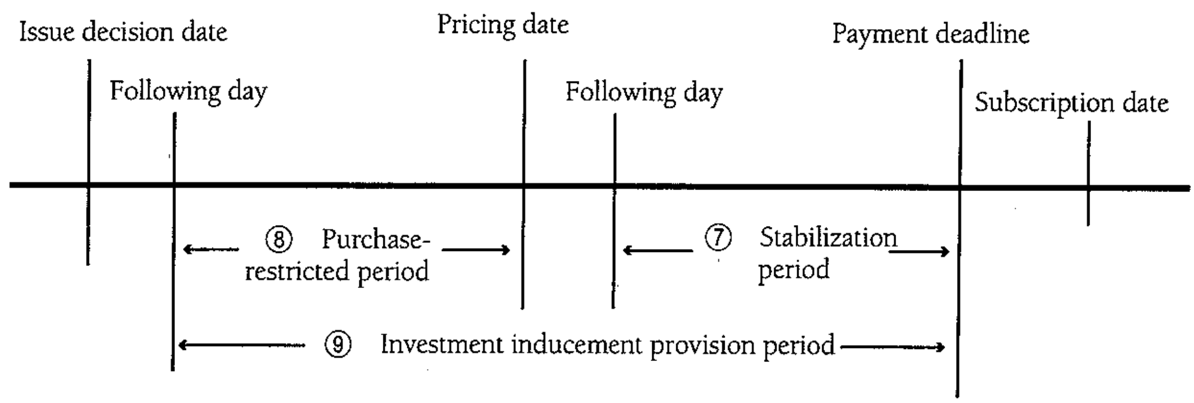
Inspections of securities companies in the year under review were conducted mainly to confirm implementation of directives from previous inspections, as well as to examine compliance with transaction rules, sales practices and internal control systems.

Improvements related to problems pointed out in previous inspections were noted in most cases, as many securities companies have worked to reinforce and strengthen internal control systems. Following is a summary of problems found during inspections completed in SESC year 1995, 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:

① Counter bucketing and bucketing (refer to page 9)	legal violation
② Inducing customers by offering definitive predictions that a stock price will rise	legal violation
③ Conclusion of discretionary trading account transaction contracts	legal violation
④ Inducement based on promise to provide profit	legal violation
⑤ Accepting securities trading transaction orders while aware that such transactions will have manipulative market effect	legal violation
⑥ Securities transactions for speculative profit	legal violation
⑦ Purchase of securities for own account during stabilization period by general underwriter (refer to page 10)	legal violation
⑧ Purchase of securities by original underwriter for own account or for the account of an affiliate between issue decision date and pricing date	violation of self-regulatory rules
⑨ Active solicitation to purchase securities of the issuing company during period* between issue decision date and subscription date	violation of self-regulatory rules

*Note: * Denotes period for own-account purchases and active investment solicitation.*



⑩ Purchasing and selling bonds at prices exceeding margin limit	violation of self-regulatory rules
⑪ Lending and borrowing names for securities transactions	violation of self-regulatory rules
⑫ Accepting orders for transactions under assumed names	violation of self-regulatory rules
⑬ Lending money to and borrowing money from customers	violation of self-regulatory rules

(2) Concerning sales practices, the following problems were found in some securities companies:

① Aggressive solicitation related to convertible bond, foreign securities and other transactions that disregard the attributes of customers;

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) The following problems related to internal controls in some securities companies have been acknowledged:

① Insufficient internal control systems;

② Insufficient awareness of directors for compliance with laws and regulations.

2. Examples of problems

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

(1) Cases concerning compliance with transaction rules

① Inducement based on promise to provide specific profit.

(Violation of Ministerial Ordinance 2(2), based on SEL Article 50(1)6)

Securities Company A on multiple occasions conducted transactions with an affiliated company related to realization of unrealized gains concerning stocks held by Securities Company A, but directors of Securities Company A made a promise to directors of the affiliated company to cover transaction expenses, thus inducing the affiliated company to conduct transactions.

Furthermore, in many of said transactions Securities Company A raised the original transaction sale price (sale by the customer to Securities Company A) higher than the original price (sale by Securities Company A to the customer), thus providing profit for the affiliated company. Through these activities, the affiliated company was able to cover various transaction-related expenses (commission, securities transaction tax, loan interest).

② A securities company, as general underwriter, traded securities for its own account, or for the account of an affiliate, between the date of offer, or the day after issue decision date, and the pricing date.

(Violation of TSE and OSE Regulation 1(1), related to Board Directive Article 59 preventing exchange members from trading on own account; violation of Article 20(2) of Rule 1 of the JSDA Fair Business Practice Regulations, related to trading and other transactions concerning OTC-registered securities).

According to self-regulatory rules, it is prohibited to trade for own account or for the account of an affiliated company in stock between the day after the Board of Directors decided to issue the stock and the date when the price of said stock is decided, in cases where the same securities company, or an affiliated company thereof, is the original underwriter for the stock issue (hereinafter referred to as "Finance Issue").

Securities Company B distributed the list of the original Finance Issue, prepared by its Trading Inspection Division, to its Stock Division. Fund managers of the Stock Division were, according to regulations, not to purchase Finance Issue for its own account. However, because the Trading Inspection Division did not report to the Stock Division about Finance Issue until the following day, or because the computerized transaction lock was not effected owing to lax administrative procedures, managers of the Stock Division made purchases of Finance Issue on the day after the issue decision date, not knowing that they were purchasing Finance Issue.

Furthermore, Securities Company C, mistakenly believing that purchase for the account of an affiliated company was permitted under self-regulatory rules, made purchases of Finance Issue for its affiliate (overseas subsidiary), due to failure of the Trading Management Division to investigate content of the order placed by the affiliate.

③ Aggressive solicitation by general underwriter for purchase of stock between day after issue decision date and subscription date.

(Violation of JSDA Fair Business Practice Regulations Article 9(8)4)

The overseas subsidiary of Securities Company D was also the underwriter of an issue of bonds with warrants. Between the day after issue decision date and subscription date of said issue, Branch A of Securities Company D actively solicited stock in the same company making said issue of bonds with warrants to customers, mistakenly believing that such activities would not be in violation of self-regulatory rules as long as there was no intention to contribute to price manipulation.

Furthermore, the Trading Inspection Division of Securities Company D, mistakenly believing that purchase of said stock would not be in violation of self-regulatory rules as long as there was no significant effect on purchase price, failed to check whether or not Branch A was conducting active solicitation.

④ Trading of bonds at prices above margin limit.

(Violation of TSE Board Directive Article 23(2), related to appropriate prices for off-market bonds; violation of JSDA Fair Business Practice Regulations Article 3, concerning rules covering OTC quotations and other announcements, as well as trading prices, related to public bonds), Clause 13)

Despite the existence of a self-regulatory rule stating that off-market bond trading must be carried out within predetermined margin limits, Securities Company E, while aware that its trader was exceeding the margin limit, concluded that the scope of excess was small and nevertheless conducted transactions according to customers' requests, resulting in execution of reversal transactions exceeding margin limits, on multiple occasions.

Furthermore, Securities Company F mistakenly believed that the actual market price arrived at through its trading activities would be the standard for calculating margin limit, despite the fact that, if the bond was listed on an exchange, the price determined by the exchange would be the standard for calculating margin limit. This resulted in execution of reversal transactions exceeding the margin limit.

⑤ Lending and borrowing names for securities transactions.

(Violation of JSDA Fair Business Practice Regulations Article 8, for regulations concerning securities company employees, Clause 9(3)23).

A sales representative of Securities Company G, in response to a request for an extra share from a customer who had received a purchase right for one share of a stock at its offering through the lottery system, used the account of another customer who had relinquished same purchase right, in order to purchase said extra share.

⑥ **Accepting orders for transactions under assumed names.**

(Violation of JSDA Fair Business Practice Regulations Article 8, Clause 9(3)24)

A sales representative of Securities Company H, responding to an inquiry from a customer about increasing the possibility of gaining stock purchase rights through the lottery system by making applications under multiple names, acknowledged this as a request and made multiple applications on behalf of same customer.

⑦ **Lending money to and borrowing from customers.**

(Violation of JSDA Fair Business Practice Regulations Article 8, Clause 9(3)29)

A sales representative of Securities Company I, on the condition that a customer would place an order for a stock purchase to said representative, opened an account for and lent money to same customer without charging interest after the account was opened.

(2) Cases concerning sales practices

① **Active solicitation ignoring the attributes of customers.**

(a) A customer of Securities Company J had previously conducted transactions mainly related to investment trusts and bonds, but requested temporary suspension of transactions. A new sales representative of Securities Company J made a recommendation to same customer to switch part of his investment trust, which was falling below par value, into convertible bonds, whereupon the content of the customer's transactions changed to convertible bonds and stocks, and the transaction volume increased. These transactions, which included revolving transactions to cut losses on below-par convertible bonds, were carried out on multiple occasions.

The sales representative persuaded the customer to sell his investment trust, which was falling below par value, and switch to below-par convertible bonds, which would produce a profit if held until redemption, arguing that in doing so, losses on the customer's investment trust could be compensated for by bond gain within two years. Based on this argument, the customer purchased said convertible bonds. Afterwards, however, the sales representative induced the customer to undertake revolving transactions to sell the same convertible bonds to cut short-term losses.

Numerous other customers of Securities Company J sold below-par convertible bonds in a short time despite the fact that they would have produced a profit if held until redemption. As a result, the securities company excessively solicited trading for the pursuit of short-term profit, providing inadequate explanation about the nature of the investment instruments, as well as according insufficient consideration to the asset volumes and investment intentions of customers.

(b) Since 1992, Securities Company K actively sold yen-denominated foreign government bonds, based on the argument that despite long-term maturity and credit risk, high return would compensate for currency risk.

A sales representative at Securities Company K induced a customer to purchase yen-denominated foreign government bonds, according to the customer's desire to invest in a stable instrument that secures a higher return than that of bank deposits. After that, the sales representative used sales talk to induce the customer to make purchases, persuading the customer that long remaining time until redemption is more important than high ultimate return, or vice versa. As a result, the same customer repeated short-term revolving transactions and shifted to similar yen-denominated foreign bonds, in which loss-cutting transactions were acknowledged.

Numerous other customers of Securities Company K engaged in short-term loss-cutting sales of yen-denominated foreign government bonds, and switched to other similar instruments. However, these investments were the result of inadequate explanation about the nature of the investment instruments to the customers, who generally lacked securities-related knowledge and experience, as well as inducement to purchase similar instruments despite the customers' lack of ability to make additional investments.

(c) Since April 1995, Securities Company L shifted the focus of its sales activities to individual investors from Japanese government bonds to foreign-denominated foreign bonds, and conducted active marketing accordingly. Based on inducement by a sales representative of Securities Company L, a customer purchased foreign-currency-denominated foreign bonds in July 1995, then sold them the following month, purchasing on the same day another foreign-currency-denominated foreign bond with the same currency and coupon rate, and practically identical characteristics. In September 1995, the same customer repeated the process, selling and then purchasing practically identical bonds on the same day. The same customer realized a profit on the sale of the bonds as a result of the weakening yen, but had to bear currency exchange and other costs as a result of switching between bonds, which would not have occurred if switching was not carried out.

Numerous other customers of Securities Company L conducted same-day switching between foreign-currency-denominated foreign bonds with practically identical characteristics, or later switched to selling foreign-currency-denominated foreign bond holdings in order to make such purchases. As a result, the sales representative, assuming that the customers would be satisfied with profits on sales of the bonds, ignored currency and other costs, engaging in excessive solicitation to switch between foreign-currency-denominated foreign bonds.

(d) Since April 1995, Securities Company M has been actively engaged in sales of bull-bear-type open-end investment trusts. A customer, due to unpredictability of stock market direction, invested in both bull- and bear-type investment trusts from a sales representative of Securities Company M. When the market moved in a certain direction, the said customer was induced to shift profits from one type to the other, and two days later the same customer made a loss-cutting divestment in both trusts. The same customer later made similar and repeated transactions—investing in both types of trust and selling on the same day within a short period of time.

Numerous other customers of Securities Company M made same-day investments in both bull- and bear-type investment trusts, followed by same-day divestments from both trusts, and instances of same-day divestment from and investment in bull- or bear-type trusts were also acknowledged. The sales representative acted through lack of consideration for the knowledge and experience of customers, with insufficient explanation about the characteristics and investment procedures of each trust type, and the customers therefore did not have adequate understanding of the investments they were making.

Note: Bull- and bear-type open-end equity investment trusts

The bull-type trust purchases futures linked to the Nikkei Average, with a view to increasing the size of the trust to 1.5 times that of the fund's net assets, so that a rise in the Nikkei Average will result in an investment return of 1.5 times the scope of the gain. The bear-type trust sells Nikkei futures, with a view to keeping the fund's net assets at essentially similar levels, so that a decline in the Nikkei Average will bring an investment return of similar scope to the fund.

② **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 N received a request from a corporate customer for transactions to realize unrealized gains on three issues, which were executed on the stock exchange (sale by customer to Securities Company N). The following day, however, the opening price of one of the issues rose above the previous day's selling price, leading to expected profit for Securities Company N.

As a result, for the other two issues Securities Company N executed return transactions (sale by Securities Company N to the customer) at prices different from market prices and lower than those of the original transactions, making adjustments to ensure that trading in the three said issues did not incur losses for Securities Company N.

(3) Internal control systems

① **Problems related to insufficient internal control systems.**

(a) In relation to commencement of high-risk stock index options transactions, Securities Company O, according to internal regulations, held interviews with customers, confirmed their knowledge and experience and received approval from the sales office managers, but owing to the perfunctory nature of the managers' approval, transactions were commenced without sufficient understanding of the will of the customers, and adequate checks were not conducted regarding the content of transactions with individual customers, with whom transaction volume was extremely large.

(b) Securities Company P, in order to make its sales offices aware of transaction status, distributed to the sales offices a list of small-volume accounts that come under set standards for short-term transactions, but since the purpose of the system was not fully explained, the list was not properly utilized, leading to a situation where the attributes of the customers were ignored.

(c) Securities Company Q, in relation to transactions with customers pointed out by the so-called Attention System, made an effort to have its sales office understand the knowledge, experience and financial status of customers to determine the existence of potential problems. The sales office, however, did not fully understand these matters. Furthermore, the sales office provided a report, suggesting improvement measures for such customers, to the head office control division, but subsequent transactions with such customers did not improve, to the extent that sufficient checks of transaction content were not undertaken, and subsequent transaction status was not fully understood.

Note: Attention System

At securities companies, numerous sales representatives solicit numerous customers on a daily basis to undertake trading and other transactions, and determining the appropriateness of such solicitation activities is fundamentally under the control of individual sales offices. To support these efforts, the head office control divisions have set up external supervision systems to monitor transaction frequency, profit-loss status and other aspects related to customers. If a customer does not meet the standards, a hearing is held with the sales representative (or an interview held with the customer if required), in order to prevent in advance the solicitation of inappropriate investments. These systems have several names, including Attention System and Alarm System, and have recently been computerized and are increasingly being adopted even by small and medium-sized securities companies.

② **Insufficient compliance with rules by securities company directors.**

(a) A person in charge of the internal control division of Securities Company R sent a warning to a sales division related to control data received concerning own-account transactions during stabilization period. The trading division misinterpreted the warning, assuming that the transactions in question were an exception, since they were not executed with a view to influencing market price. This situation of miscommunication between the two divisions continued for a long period, and since a system to enforce compliance with rules was not quickly put in place, repeated violations of laws were acknowledged.

(b) The majority of securities-related mishaps at Securities Company S were traced to the market weakness and relative youth of the sales staff. A closer look revealed many cases in which sales representatives emphasized the positive aspects of investment instruments but mistakenly failed to sufficiently explain risks and other issues, and also undertook trading without adequately confirming the will of the customers. It was acknowledged that these sales representatives had insufficient understanding and compliance awareness of rules and regulations, and also had insufficient understanding of the nature of investment instruments.

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 during the year under review.

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.