

I. Outline

I. Significance of market surveillance

The objective of market surveillance conducted by the SESC is to ensure the fairness of securities transactions and the protection of investors. These activities are carried out under the authority delegated by the Minister of Finance as prescribed in the SEL, LFSF and FFTL. The SESC meets its objectives by undertaking day-to-day monitoring of market activities, through

collection of detailed reports about securities transactions and necessary materials for daily market surveillance from securities companies and SROs.

As with the SESC's inspections, the authority to collect reports and materials is entrusted to directors-general of regional finance bureaus. (If necessary, however, the SESC can exercise said authority independently.)

Entities from which reports and materials are collected are listed as follows:

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 exchange 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 market surveillance authority from the Minister of Finance.

2. *Scope of market surveillance*

The scope of market surveillance is regulated by the Cabinet Order (SEL Enforcement Order Articles 16, 17(5), 18(2) and 19(2); LFSF Enforcement Order Article 14; FFTL Enforcement Order Articles 3, 4, 7 and 10), prohibiting market manipulation, circulating rumors, insider trading and the activities of certain securities companies, their directors and employees.

3. *Viewpoint and emphasis of market surveillance*

Market surveillance focuses on the following points:

- ① Stocks experiencing sharp price rises and drops;
- ② Stock price movements before and after corporate accounting periods;
- ③ Stock price movements for convertible bond issues before, on or after conversion price calculation dates;
- ④ Stock price movements before and after cross-transactions;
- ⑤ Stocks for which information appeared that significantly influenced the decisions of investors;
- 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 in general;
- ② Whether such transactions violate securities exchange 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 endeavors to clarify problems by conducting 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 the year under review, cases of detailed market surveillance were as follows:

Related to market manipulation	158 cases
Related to insider trading	54 cases
Related to other items	3 cases

Details of market surveillance conducted by the SESC and regional finance bureaus were as follows:

Conducted by the SESC	132 cases
Conducted by regional finance bureaus	83 cases

Table 4: Results of Market Surveillance

(Unit: cases)

Category	SESC Year 1992	SESC Year 1993	SESC Year 1994	SESC Year 1995
Related to market manipulation	154	162	111	158
Related to insider trading	12	50	62	54
Others	4	5	22	3
Total	170	217	195	215
SESC	75	102	107	132
Regional finance bureaus	95	115	88	83

2. Summary of surveillance results

In the year under review, numerous instances of sudden stock price increases were seen in the wake of general market recovery, and the SESC stepped up the number of surveillance cases accordingly. Surveillance of market manipulation centered on trading by specific group of investors, in which stock prices suddenly surged, as well as cases in which stock prices fluctuated significantly at the end of the fiscal year. Surveillance of insider trading focused on cases in which the decisions of investors were thought to have been influenced considerably, such as cases in which stock prices fluctuated significantly following announcements of such information as the issuing of new stocks, amendments of expected business results, damages caused by business operations, stock splits and merger activities.

Regular market surveillance through these activities functions both as a direct and indirect deterrent to unfair transactions.

Surveillance cases during the year under review were as follows:

Surveillance related to manipulation

① During the period in which the stock price of stock-issuing Company A rose sharply, in accordance with

considerable transaction volume, a specific group of investors was purchasing stocks issued by Company A and was also requesting conversion of large volumes of convertible bonds into stocks using multiple names, consequently ordering purchases of stock below round lots.

② On multiple stocks, some investors made cross transactions among themselves in the same specific group (“matched orders”), and also made successive purchases at prices higher than the latest contract price through limit and market orders (“advancing the bid”), thus influencing closing prices (“marking the close”) on many occasions.

③ Information was received regarding the stock price of Company B, which rose sharply as a result of multiple securities companies driving up the price by trading with each other on their own accounts.

④ The stock prices of multiple issues rose following the close of the fiscal year, and it could be argued that this resulted from the activities of certain parties seeking to avoid write-down from evaluation of stockholdings by lower of cost or market method.

⑤ The prices of multiple over-the-counter stocks rose sharply at about the same time, in accordance with considerable transaction volume, despite the absence of special information that would affect stock prices during the period of the rise.

Surveillance related to insider trading

① Stock-issuing Company C announced the release of a new product, but immediately before the announcement the president of Company C described contents of the announcement at a gathering of stockholders, and it was acknowledged that there was a high possibility that attendees of the gathering purchased said stock.

② A certain company announced that it had repurchased more than 5% of outstanding shares in stock-issuing Company D. However, it was acknowledged that employees of the said purchasing company and business associates of Company D had purchased stocks issued by Company D prior to said announcement.

③ Stock-issuing Company E announced that there was considerable possibility of losses arising from evalua-

tion of stockholdings, as its subsidiary reported substantial accumulated losses and reduction of capital. However, it was acknowledged that, prior to said announcement, directors of Company E and their asset management company had sold stocks issued by Company E.

④ Stock-issuing Company F announced that it had incurred substantial extraordinary losses as a result of its cancellation of interest-rate swap transactions. Prior to said announcement, however, it was acknowledged that the subsidiary of Company F had sold stocks issued by Company F.

⑤ Stock-issuing Company G announced a capital increase through a third-party allocation. Prior to said announcement, however, transaction volume of stocks issued by Company G rose suddenly despite absence of special information, and multiple persons, thought to be affiliated together in the same specific group, had purchased large volumes of stocks issued by Company G, which they sold at a higher price following said announcement, it was acknowledged.

The Minister of Finance must consult with the SESC regarding inspection plans and basic matters (MFEL, Article 21(1)). This provision also obliges the Minister of Finance to request SESC advice and enables the SESC to make necessary proposals regarding the policies of inspecting financial institutions, foreign currency exchange and securities companies (financial soundness). Proposals, made in view of the value of objective opinions by nonadministrative 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. If necessary, the SESC can make proposals to the Minister concerning the operation and policies of inspections of financial institutions (MFEL, Article 21(2-3)).

In SESC year 1995, no cases were acknowledged of problems on inspections operations that required proposals.

I. Relationship between the SESC and SROs

SROs (such as securities dealers associations, stock exchanges, financial futures dealers associations and the Financial Futures Exchange) conduct surveillance activities of their members and make self-regulatory rules to ensure the fairness and transparency of the market. These activities determine whether member companies operate appropriately according to laws, regulations and self-regulatory rules. In this manner, the SROs operate hand-in-hand with the SESC.

Nevertheless, the SESC assumes the right to examine the activities of SROs to determine whether surveillance is conducted appropriately and whether SROs are imposing strict sanctions against members who violate laws, regulations and self-regulatory rules.

The SESC maintains close interactive relationships with SROs, with which it holds hearings on such matters as the state of surveillance.

Following are activities reported by SROs:

II. Activities of the Japan Securities Dealers Association

The activities of the JSDA during fiscal 1995 (April 1, 1995, to March 31, 1996) were as follows:

1. Status of surveillance of association members

(1) Main surveillance items

Items of surveillance of regular members (domestic and foreign securities companies) include the following: (1) observation of "principles of suitability;" (2) observation of regulations related to prohibited acts through securities transactions; (3) management of securities transactions; and (4) management related to clearing and settlement of cash and securities.

(2) Conduct of surveillance

In fiscal 1995, surveillance was conducted on 90 companies: 76 domestic and 14 foreign securities companies.

(3) Summary of results

Surveillance conducted in fiscal 1995 revealed a number of violations of laws and regulations, including ① disregard for "principles of suitability," such as delays in preparing customer cards and omission of necessary items on those cards, and delays in collection of confirmation statements for over-the-counter and other transactions; ② disregard for regulations related to prohibited acts during securities transactions, such as receipt of orders under assumed names, use of borrowed names and insufficient screening to determine custom-

ers' official names; ③ problems related to management of securities transactions, such as lack of distinction between own account and customer orders received regarding futures and other transactions, delays in collection and insufficient accounting for moneys accepted for purchase of over-the-counter securities, as well as delays in and insufficient accounting for registration cards related to insider trading transactions; and ④ management problems related to clearing and settlement of cash and securities, such as delays in delivery and collection of securities depository receipts.

In cases where improvement was particularly necessary, in addition to directing member associations

the JSDA requested that these members report on improvements in the situation. In fiscal 1995, such requests were made to 17 companies in relation to such matters as using assumed and borrowed names.

Note: Principles of suitability

"Principles of suitability," based on the premise that there are many cases in which securities companies have significant influence over customers' investment decisions, call for securities companies to give advice based on the investor's actual circumstances, and for securities companies to actively undertake appropriate screening to determine investment objectives, financial status and other circumstances related to customers.

Table 5: Inspections by the JSDA

(1) Regular Members

(Unit: companies)

Classification	Fiscal 1992 April 1, 1992, to March 31, 1993	Fiscal 1993 April 1, 1993, to March 31, 1994	Fiscal 1994 April 1, 1994, to March 31, 1995	Fiscal 1995 April 1, 1995, to March 31, 1996
Domestic securities companies	109	105	110	76
Foreign securities companies	21	25	20	14
Total	130	130	130	90

(2) Special Members

(Unit: companies)

Classification	Fiscal 1994 April 1, 1994, to March 31, 1995	Fiscal 1995 April 1, 1995, to March 31, 1996
City Banks	2	9
Regional Banks	3	21
Regional Banks II	4	22
Shinkin Banks	2	14
Life Insurance Companies	2	6
Non-Life Insurance Companies	1	7
Others	1	2
Total	15	81

Note: "City Banks" refers to city banks, long-term credit banks, trust banks and government financial institutions. "Shinkin Banks" includes shinkin banks and The Zenshinren Bank, and "Others" includes call loan and discount companies and foreign banks.

2. Status of surveillance of special members

(1) Main surveillance items

Items of surveillance of special members (financial institutions licensed to provide securities services) include the following: ① management of securities transaction orders; ② compliance with rules related to prohibited acts through securities transactions; ③ management of the execution and clearing of securities

transaction orders and custody of securities; and ④ management related to the processing of securities transactions.

(2) Conduct of surveillance

Surveillance of special members is primarily delegated by the JSDA to the associations regularly organized by said special members (six in total), such as the Federa-

tion of Bankers Association of Japan. The associations implement surveillance with personnel designated by the JSDA. In fiscal 1995, surveillance was conducted on 81 financial institutions (52 banks, 14 *shinkin* banks, 13 insurance companies and two call loan and discount companies). No violations of regulations or other problems were acknowledged in particular as a result of this surveillance.

3. Conducting securities market surveillance

(1) Summary of surveillance

It is the duty of the JSDA's OTC Stock Watching Department, which is responsible for investigation of securities transactions, to collect market information related to stocks registered over-the-counter and monitor stock prices and trading volume, as well as to collect

information on members' participation in transactions. When necessary, the Department conducts close surveillance when it observes irregularities in securities transactions. Alternatively, the Department investigates when the OTC Stock Market Section of the Securities Business Department reports on information having a wide-ranging influence on stock prices.

The Department maintains close relationships with these departments in the area of market surveillance. After the Department obtains results of initial surveillance, if necessary it requests that the Member Firm Inspection Department conduct further investigation.

(2) Surveillance results

Surveillance was conducted in fiscal 1995 as follows:

Issues surveyed (selected because they fall under specific criteria):	2,369 issues
Market manipulation	1,409 issues
Insider trading	958 issues
Others	2 issues
Issues investigated (requiring more detailed investigation based on results of above surveillance):	40 issues
Market manipulation	20 issues
Insider trading	18 issues
Others	2 issues

In addition to the surveillance activities described above, the office monitored real-time price movements to prevent other inappropriate acts from occurring.

(3) Summary of surveillance results

When inappropriate securities transactions are uncovered through surveillance, according to its Articles of Association the JSDA takes disciplinary measures against

the members involved.

In addition, when securities transactions are suspected, but not proven, to be inappropriate, the JSDA cautions the members involved. The JSDA also provides necessary directions for the acceptance and execution of orders to ensure fairness in over-the-counter price formation.

Table 6: Market Surveillance by the JSDA

(Unit: issues)

Classification	Fiscal 1992 April 1, 1992, to March 31, 1993		Fiscal 1993 April 1, 1993, to March 31, 1994		Fiscal 1994 April 1, 1994, to March 31, 1995		Fiscal 1995 April 1, 1995, to March 31, 1996	
	Surveillance	Investigation	Surveillance	Investigation	Surveillance	Investigation	Surveillance	Investigation
	Market manipulation	445	2	858	76	1,292	14	1,409
Insider trading	654	12	917	14	745	25	958	18
Others	15	15	7	90	14	9	2	2
Total	1,114	29	1,782	90	2,051	48	2,369	40

- Notes: 1. "Surveillance" refers to issues selected that met certain criteria for conducting surveys.
 2. "Investigation" indicates issues surveyed that required more detailed surveillance.

(4) Summary of penalization of association members

Disciplinary actions that the JSDA can take with the resolution of its Board of Directors include reprimands, the imposing of negligence penalties up to ¥100 million, the suspension or restriction of membership for a period not to exceed six months, or the revocation of membership.

Pursuant to Article 25 of the JSDA Articles, allowing the opportunity for a satisfactory explanation, the Association can take these disciplinary actions against members in cases of violations of laws or regulations, or against members that act in violation of the principles of fair and equitable trade. These actions fall within the purview of Article 25 of the JSDA Articles, based on which disciplinary actions are taken.

During fiscal 1995, one reprimand and one penalty, totaling ¥10 million, were given according to Article 25 of the JSDA Articles. This penalty was imposed in conjunction with disciplinary actions based on SESC recommendations.

III. Activities of Stock Exchanges

Following are the activities of stock exchanges in fiscal 1995 (April 1, 1995, to March 31, 1996):

1. Status of inspections

(1) Main inspection items

Items of inspection of stock exchange members and special participants are generally classified as follows:

- ① compliance with regulations related to margin transactions and futures and options transactions;
- ② administration of customer accounts;
- ③ compliance with regulations related to commissions; and
- ④ compliance with other rules, regulations and "principles of suitability."

Note: "Special participants" refers to financial institutions other than members that are certified to participate directly in financial futures transactions on stocks listed on stock exchanges.

(2) Conduct of inspections

In fiscal 1995, inspections were made of 36 companies on the TSE (24 domestic securities companies, eight foreign securities companies and four special participant companies), and 22 domestic securities companies on the Osaka Securities Exchange (OSE).

Table 7: Inspections by Stock Exchanges

(Unit: companies)

Classification	TSE				OSE			
	Fiscal 1992	Fiscal 1993	Fiscal 1994	Fiscal 1995	Fiscal 1992	Fiscal 1993	Fiscal 1994	Fiscal 1995
Domestic securities companies	49	55	46	24	18	19	20	22
Foreign securities companies	13	11	13	8	—	—	—	—
Special participant companies	4	6	6	4	—	—	—	—
Total	66	72	65	36	18	19	20	22

(3) Summary of inspection results

The results of inspections carried out by the TSE and OSE in fiscal 1995 revealed many incidents, including ① failure to observe laws and regulations related to margin, futures and options transactions, including delays in collection of agreements to set up transaction accounts for margin and futures transactions, as well as shortages of and delays in making consignment guarantee money deposits; and ② problems related to management of customers' accounts, including acknowledgment of advances of loss amounts for transaction settlements and advances of purchase amounts for margin transactions, and acknowledgment of confusion between customers' accounts for collateral secu-

rities and moneys, as well as violations of laws and regulations related to commission collection errors and nonmarket trading of listed bonds that exceeded price-range limits.

According to the results of inspections, stock exchanges requested their members and special participants to submit reports and provided directions as necessary for the improvement of operational disposition (in fiscal 1995, directions provided to three companies for insufficient internal control systems related to advances for TSE transactions, and one company for inappropriate use of consignment guarantee collateral securities for OSE transactions).

2. Conducting securities market surveillance

(1) Summary of surveillance

Taking the TSE as an example, the Department of Market Surveillance and Compliance conducts investigations and surveys of issues selected by examining collected market information, issues notified by the Stock Market Department and Bond Market Department as abnormal in their trading, and issues reported by the Office of Listings Supervision as discharging

material information influencing investment decisions. Thus, the Department of Market Surveillance and Compliance works on market surveillance in close cooperation with these departments.

In addition, the Stock Market Department and the Bond Market Department also monitor real-time price movements to prevent inappropriate transaction-related activities from occurring.

(2) Conduct of surveillance

The total number of issues investigated by the TSE in fiscal 1995 are as follows:

Issues surveyed (selected because they fall under specific criteria):	1,942 issues
Market manipulation	115 issues
Insider trading	1,707 issues
Others	120 issues
Issues investigated (requiring more detailed investigation based on results of surveillance):	192 issues
Market manipulation	41 issues
Insider trading	88 issues
Others	63 issues

In addition, the Stock Market Department and the Bond Market Department also monitor real-time price movements to prevent inappropriate transaction-related activities from occurring.

(3) Summary of surveillance results

When inappropriate transactions are uncovered through investigations, stock exchanges impose sanctions against

the members involved in view of preventing such transactions.

In addition, when securities transactions are sus-

pected but not proven to be inappropriate, stock exchanges issue cautions to the concerned members.

Furthermore, stock exchanges provide necessary

directions for the acceptance of orders that will ensure fairness in price formation.

Table 8: Market Surveillance by the TSE

(Unit: issues)

Classification	Fiscal 1992 April 1, 1992, to March 31, 1993		Fiscal 1993 April 1, 1993, to March 31, 1994		Fiscal 1994 April 1, 1994, to March 31, 1995		Fiscal 1995 April 1, 1995, to March 31, 1996	
	Surveillance		Surveillance		Surveillance		Surveillance	
		Investigation		Investigation		Investigation		Investigation
Market manipulation	834	114	265	133	138	57	115	41
Insider trading	1,690	52	1,767	64	1,625	63	1,707	88
Others	19	5	72	29	46	6	120	63
Total	2,543	171	2,104	226	1,809	126	1,942	192

- Notes: 1. "Surveillance" refers to issues selected that met criteria for conducting surveys.
2. "Investigation" indicates issues surveyed that required more detailed surveillance.

3. Summary of sanctions against members

Pursuant to Article 50 of the TSE Charter, if the stock exchange deems that a member has violated laws, regulations, its charter, or just and equitable principles of trade, the exchange may, after providing the opportunity for a hearing from the member, impose sanctions such as negligence penalties of up to ¥100 million; censure; suspension from or restriction on transactions in the market of the exchange; suspension of member-

ship for up to six months; and revocation of membership.

Pursuant to Article 55 of the TSE Charter, if a member undergoes disciplinary actions, such as business suspension, business restriction or license revocation, based on the extent of the above disciplinary actions the exchange shall suspend or restrict said member's transactions in the market of the exchange or revoke exchange membership.

In fiscal 1995, sanctions by the TSE under Article 50 of its charter included one negligence penalty, totaling ¥8 million, and one censure; and under Article 55, two cases in which limitations on securities transactions were imposed. In addition, under Article 55 of its charter, the OSE imposed sanctions in two cases, both of which were carried out in conjunction with inspection conducted by the SESC.

IV. Activities of the Financial Futures Dealers Association of Japan

Following are the surveillance activities of the Financial Futures Dealers Association of Japan in fiscal 1995 (April 1, 1995, to March 31, 1996):

(1) Main surveillance items

Items of surveillance of association members include

management of financial futures transaction orders, management of customers' margin, and compliance with rules concerning regulating financial futures transactions.

(2) Conduct of surveillance

In fiscal 1995, surveillance activities were carried out on 18 member companies (nine banks, seven securities companies, and two companies in the call loan and discount and other business fields).

(3) Summary of surveillance results

The following incidents were discovered during surveillance activities in fiscal 1995: omission of necessary items on customer management cards and order forms, and insufficient management of agreements to set up transaction accounts. The association advised the members involved to correct these points.

**Table 9: Market Surveillance by the Financial Futures
Dealers Association of Japan**

(Unit: companies)

Category	Fiscal 1992 <i>April 1, 1992, to March 31, 1993</i>	Fiscal 1993 <i>April 1, 1993, to March 31, 1994</i>	Fiscal 1994 <i>April 1, 1994, to March 31, 1995</i>	Fiscal 1995 <i>April 1, 1995, to March 31, 1996</i>
Banks	—	6	8	9
Securities companies	—	3	7	7
Call loan and discount companies	1	2	2	1
Others	—	2	1	1
Total	1	13	18	18

- Notes: 1. "Call loan and discount companies" refers to call loan and discount companies and foreign exchange brokers.
2. "Others" indicates futures companies and *shinkin* banks.

V. Activities of the Financial Futures Exchange

Following are the activities of the Financial Futures Exchange in fiscal 1995 (April 1, 1995, to March 31, 1996):

1. Inspection results

(1) Main inspection items

Items of inspection of exchange members include management of financial futures transaction orders, compliance with rules related to prohibited acts during financial futures transactions, and management of internal control systems.

(2) Conduct of inspections

In fiscal 1995, inspections were carried out on 11

member companies (six banks, two securities companies and three companies in the call loan and discount and other business fields).

(3) Summary of inspection results

Following inspections carried out in fiscal 1995, the Exchange sent directives to rectify a number of problems, including omission on necessary legal book-keeping items on order forms and on agreements to set up transaction accounts; and lack of distinction between own account and customer orders.

2. Activities of the Surveillance Section

Regarding transaction surveillance, because all transactions are systematized surveillance software has been specially developed to regularly monitor transactions. Also, as required hearings are held for members.