Chapter 2 Inspections

I. Outline

1. Significance of inspections and parties inspected

The SESC conducts on-site inspections of securities companies and related organizations to supervise their compliance with laws and regulations concerning the maintenance of fairness in securities and other transactions. SESC inspections are carried out under the authority delegated by the Prime Minister (the Commissioner of the Financial Supervisory Agency) as prescribed in the SEL, LFSF and FFTL.

The objective of the SESC's inspections is to protect the public interest and investors. The SESC's inspections are expected to support the Prime Minister (the Commissioner of the Financial Supervisory Agency) in taking necessary measures and formulating policies concerning securities companies.

Part of the SESC's authority to conduct inspections and collect reports and materials is delegated to Directors-General of regional finance bureaus. (If necessary, however, the SESC may exercise this authority by itself.)

Specifically, the following institutions are subject to the SESC's inspection:

- o Securities companies and their parent financial institutions
- o Financial institutions licensed to provide securities services
- o Japan Securities Dealers Association (JSDA)
- o Stock exchanges
- o Branches of foreign securities companies and specified financial institutions
- o Financial futures exchanges and their members
- o Financial futures dealers
- o Japan Financial Futures Dealers Association (JFFDA)

2. Scope of inspections

The scope of SESC inspections is regulated in Cabinet Orders (Article 38 of the SEL Enforcement Order, Article 17 of the LFSF Enforcement Order, and Articles 7, 8, 9, and 10 of the FFTL Enforcement Order). For example, the SESC is authorized to conduct inspections in the light of possible violations of laws and regulations by securities companies and their directors or employees (including discretionary trading account transactions, solicitation with definitive predictions, solicitation with promises of special profit, etc.), as well as such violations as loss guarantees and compensation, market manipulation, and insider trading.

II. Basic Policy and Plan for Inspections

Inspections periods are based on SESC years, from July 1 to the following June 30.

Basic policies and plans for inspections are established each SESC year in order to ensure that all inspections by the SESC and those by Directors-General of regional finance bureaus under the delegated authority are managed and conducted strategically.

In basic policies for inspections, important inspection items and other basic matters are determined. In basic plans for inspections, the numbers and other matters are determined concerning inspections of domestic and foreign securities companies, and financial institutions licensed to provide securities services, respectively, during the year.

III. Results of Inspections

1. Inspection status

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

(1) Inspections of securities companies

During the year under review, the SESC and regional finance bureaus commenced inspections of 79 securities companies, one SRO, and one financial futures dealer.

Of this total, the SESC commenced inspections of seven domestic securities companies, eight branches of seven foreign securities companies, and one SRO. Regional finance bureaus commenced inspections of 65 domestic securities companies and one financial futures dealer.

Regarding inspections commenced during the year under review, inspections were completed on 59 domestic securities companies and eight branches of seven foreign securities companies with the presentation of "Notice of Conclusion" to the companies (Table 1). In addition, inspections commenced in SESC year 1996 but not completed by June 30, 1997, were completed during the year under review. These included inspections of 28 domestic securities companies, two foreign securities companies, and one financial institution licensed to provide securities services.

Following the SESC's recommendations based on inspections concluded in SESC year 1997 (including those commenced in the previous year), the Minister of Finance took administrative disciplinary actions against 10 securities companies and 58 directors and employees of securities companies for their grave violations of laws and regulations, such as suspension of operations (detailed in Chapter 3).

Problems found through these inspections were reported by the SESC to the administrative sections, which then issued directives for improvement to the securities companies inspected.

(2) Inspections of financial futures dealers

In SESC year 1997, when the SESC conducted inspections of securities companies, inspections of these companies as financial futures dealers were conducted at the same time.

2. Total personnel per inspection

In SESC year 1997, 111 man-days were assigned per inspection (on-site period basis) for domestic securities companies, 49 man-days for foreign securities companies, 20 man-days for financial futures dealers, and 85 man-days for SROs (see Table 2).

Table 1: **Inspection Status**

Category	SESC Year 1993	SESC Year 1994	SESC Year 1995	SESC Year 1996	SESC Year 1997
Securities companies	87	85	86	83	79
Domestic	79	79	84	80	72
(SESC)	(9)	(10)	(9)	(12)	(7)
(Regional finance bureaus, etc.)	(70)	(69)	(75)	(68)	(65)
Foreign	8	6	2	3	7
(SESC)	(8)	(6)	(2)	(3)	(7)
(Regional finance bureaus, etc.)	(–)	(–)	(–)	(–)	(–)
Branch inspections	17	22	15	26	31
Financial futures dealers	–	–	–	–	1
(SESC)	(–)	(–)	(–)	(–)	(–)
(Regional finance bureaus, etc.)	(–)	(–)	(–)	(–)	(1)
Financial institutions licensed to provide securities services	13	11	10	7	–
(SESC)	(3)	(1)	(0)	(0)	(–)
(Regional finance bureaus, etc.)	(10)	(10)	(10)	(7)	(–)

Notes: 1. All inspections of foreign securities companies were carried out by the SESC.
2. The category "Branch inspections" shows the number of inspections that regional finance bureaus conducted on securities companies under the jurisdiction of the Ministry of Finance.

Table 2: **Total Personnel per Inspection**

Category		SESC Year 1993	SESC Year 1994	SESC Year 1995	SESC Year 1996	SESC Year 1997
Securities companies		154	155	212	190	160
	Domestic	111	108	107	109	111
	Foreign	43	47	105	81	49
Financial institutions licensed to provide securities services		20	15	14	12	–
SROs		–	–	–	–	85
Financial futures dealers		–	–	–	–	20

IV. Results of Securities Company Inspections

1. Problems acknowledged through inspections

Inspections of securities companies in the year under review were conducted mainly to examine their (1) compliance with transaction rules; (2) sales practices, including investment solicitations; and (3) internal control systems. Another important focus was to confirm improvement in their problems found through previous inspections.

Among the 97 companies of which inspections were completed, problems were found with 74 companies. Of the 74, inspections found numerous problems with 73 companies. These included violations of transaction rules, such as the conclusion of discretionary trading account transactions contracts, transactions of securities with the intention of pursuing speculative profit, and so on. Inspections also revealed many problems related to securities companies' sales practices and internal control systems. In addition, although the SESC found general improvements on the problems revealed through previous inspections, as for some specific points, similar problems occurred repeatedly or "securities accidents" have increased recently.

In the year under review, the SESC uncovered a particularly large number of serious violations of laws, for which it made recommendations to the Minister of Finance. These are believed to have been caused by a lack of awareness of the importance of compliance among company directors and employees, as well as insufficient internal control systems. It is necessary that the directors and employees of securities companies strengthen their awareness of the importance of compliance and strive to implement fair business practices. Also, securities companies themselves must work to build effective internal control systems.

As for problems related to the compliance with transaction rules, the SESC noted violations of laws, such as the conclusion of discretionary trading account transaction contracts, securities transactions for speculative profit, as well as numerous instances of violations of self-regulatory rules, including the acceptance of orders under customers' assumed names. New problems revealed through inspections included the sale of securities on the companies' own accounts without owning the securities, failure to submit transaction reports to customers, and the submission of transaction reports containing falsified information to customers. The SESC also uncovered cases concerning visits of securities companies' employees to customers accompanied by directors and employees of those companies' parent banks without the customers' request.

As for problems related to sales practices, in some instances the profit of customers was made light of, or insincere or unfair acts were conducted in solicitation. In one case, a securities company failed to return purchase commissions of investment trust certificates to its customers without applying a switching benefit system. In another case, preferential methods were not taken because of an insufficient understanding of the commission system when recommending customers to make a switch between different investment trust funds. In yet another case, unreasonable recommendations from an economic point of view, such as switching from one investment trust fund to another that would produce opposite results, were repeated.

As for internal control systems, despite measures adopted by various companies to strengthen their systems there were still several problematic examples. These included a prolonged failure to comprehend violations of laws and inappropriate solicitation, due to the perfunctory manner of interviews with customers or limited items in customer management, as well as a failure to report mistakes despite knowing violations of laws. These examples illustrate that control systems have not been deployed accurately or effectively, and that persons directly involved in controlling such systems lacked the awareness of the importance of compliance and rules.

Following is a summary of problems found during inspections completed in SESC year 1997, including those commenced in the previous SESC year:

(1) Concerning the observance of transaction rules, the following problems were found in some securities companies:

Violations of laws that led to recommendations

[1] Counter-bucketing and bucketing

[2] Failure to submit transaction reports or submission of falsified reports to customers

[3] Conclusion of discretionary trading account transaction contracts

[4] Solicitation with the promise of special profit

[5] Continued acceptance of securities transaction orders, knowing that such actions will have a manipulative effect on the market

[6] Continued securities transactions to realize market prices that do not reflect real factors

[7] Securities transactions for speculative profit

[8] Visits to customers accompanied by directors and employees of parent bank without the customers' request

[9] Solicitation with the promise to compensate for losses

[10] Provision of property gains to compensate for losses

[11] Provision of property gains to give customers additional profit

[12] Sale of securities on a company's own account without owning the securities

Violations of laws that did not lead to recommendations

[13] Purchase of securities by a primarily underwriting securities company on its own account during stabilization period

Violations of self-regulatory rules

[14] Solicitation for the purchase of securities before the announcement of the off-floor sale of securities

[15] Limit sale of securities on a securities company's own account prior to conducting limit sale of securities on a customer's account at a higher price than the customer's limit price (violation of principle to prioritize consignment orders)

[16] Purchase of securities by primarily underwriting securities company on its own account during purchase-restricted period

[17] Transactions of bonds at prices exceeding the limitation

[18] Failure to explain that the disclosure of informa-

tion about a company whose stocks are listed abroad is not obliged under the SEL

[19] Transactions by sales representatives without customers' consent

[20] Acceptance of securities transaction orders under borrowed names from sales representatives

[21] Acceptance of securities transactions orders under assumed names

[22] Borrowing of customers' names by sales representatives

[23] Lending money to and borrowing money from customers

[24] Advertisement based only on sales representatives' information

[25] Aggressive solicitation by primarily underwriting securities company during investment solicitation provision period

[26] Insufficient separation in placing orders of futures transactions between ones on a company's own account and ones on customers' accounts

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

[1] Solicitation for open investment trusts and convertible bonds disregarding profits of customers

[2] Adjustment by a securities company of profits or losses resulting from profit-taking transactions with a customer by conducting other profit-taking transactions with the same customer

[3] Inappropriate acceptance of orders for stock index futures or other transactions

(3) Concerning internal control systems, the following problems were found in some securities companies:

[1] Insufficient internal control systems and insufficient exercise of internal control systems

[2] Insufficient awareness by directors and employees of the importance of compliance with laws and regulations

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

In the year under review, the SESC did not conduct inspections of financial institutions licensed to provide securities services.

VI. Results of Inspections of Financial Futures Dealers

No particular problems were found regarding compliance with transaction rules or sales practices, including investment solicitation.

VII. Results of Inspections of Self-Regulatory Organizations

An amendment to the SEL (so-called "Fairness Assurance Law") in July 1992 clarified the nature of the JSDA as an SRO and precipitated the formation of an SRO system. As the Financial System Reform progresses in the future, there will be more and more demand for assuring transparency and fairness in securities markets. There is a need for the JSDA to strengthen and upgrade its operations (including auditing and taking disciplinary actions) to ensure fairness in securities transactions. The JSDA must also play a major part as market watcher while cooperating with the SESC.

Under this pretext, on April 15, 1998, the SESC began the inspection of the JSDA to check the enforcement status of its fairness assurance measures.

Note: These inspections were completed on July 9, 1998, after the close of SESC year 1997. Therefore, the result of these inspections is not required to be referred to in this report. However, we show here a summary of the SESC's findings.

Inspections revealed that procedures and systems adopted by the JSDA to assure fairness in securities transactions were still inadequate, and that improvements are required in the following areas:

1. *Reassessing auditing procedures in the following ways, to ensure more efficient and effective audits:*

(1) Conduct audits to check the compliance with laws through focused auditing procedures, rather than extensive and perfunctory audits, and rigorously enforce such practices

(2) Reinforce preparations prior to audits, such as gathering, analysis, and study of information about member companies to be audited

(3) Increase the number of branches to be audited, rather than limiting audits to head offices; at the same time, expand the current six-month operation period

subject to the audit, as deemed appropriate according to items concerning the audit

(4) Conduct on-site inspections as a basis, while conducting documentary audits according to companies audited and objectives of the audit

2. Strengthening the ability to comprehensively analyze audit results in order to improve auditing skills, while developing new techniques for auditing to cope with increasingly complicated securities transactions.

3. Setting up viewpoints and enforcement standards for judging responsibilities of member companies for violations of laws and regulations by their directors and employees, and acting as an SRO to take appropriate enforcement actions against member companies.

4. To date, recommendations made with the intention to reinforce compliance with laws and improve internal control systems of member companies have been mainly conducted in parallel with actions against member companies. Even if actions are not taken against member companies, however, recommendations should be actively made, calling for corrections in areas where the compliance of member companies with laws is deemed insufficient, as proved by repeated accidents, etc.

5. Setting up systems that facilitate the implementation of the above measures, and striving to increase the number of auditors.