

Because criminal investigations of loss compensation by the four major domestic securities companies revealed problems related to their internal controls for ensuring compliance with laws, on December 24, 1997, the SESC made a proposal to the Minister of Finance to devise necessary and appropriate measures as follows:

1. Institutionalization of the separation of customers' transactions from those on securities companies' own accounts

Through improper use of computers, all of the four major securities companies moved transactions on their own accounts to the customers' accounts as if they were made by their orders. Through these acts, the companies provided property gains for the purpose of loss compensation.

In order to prevent such methods of loss compensation, it is necessary to set up SRO regulations obliging securities companies to clearly distinguish between brokerage transactions and their own transactions, and monitor the compliance with such regulations.

Moreover, internal procedures of securities companies should be made strict to assure the proper operation and management of time recorders and prevent the inappropriate operation of computers.

2. Strengthening and upgrading internal controls to ensure compliance with laws

Responding to improper acts related to securities companies' internal controls in 1991, the JSDA established Article 13 of the Fair Practices Rules, entitled "Rules Concerning Internal Control Managers of the JSDA Members" (hereinafter referred to as "Internal Control Rules"). These rules have formed the basis for devising internal control systems for securities companies. A look at internal control systems of the four major securities companies, however, reveals that those systems have failed to deal with improper acts involving operation managers, and that the accounts under the control of the head offices have been exempted from internal controls. It is thus concluded that internal controls are not functioning effectively.

Therefore, it is necessary to strengthen and upgrade internal control systems by improving internal control rules to address this situation.

The Minister of Finance devised the following improvement measures in response to the SESC's proposals:

1. Institutionalization of the separation of customers' transactions from those on securities companies' own accounts

(1) When conducting securities transactions, the JSDA members are obliged to clearly distinguish between transactions on their own accounts and those on their customers' accounts. They are also obliged to set up internal rules to assure the proper operation and management of time recorders and prevent the improper operation of computers.

(2) When placing orders with the Japan OTC Securities Company for transactions of over-the-counter transactions, the JSDA members are obliged to make clear distinctions between securities transactions on their own accounts and those on their customers' accounts.

(3) When members of securities exchanges place orders with the exchanges, they are obliged to clarify to the exchanges whether transactions concerning the orders are conducted on their own account or on their customers' accounts.

(4) With respect to transactions through the computer systems of exchanges and the JSDA, those systems are not allowed to accept orders unless it is made clear whether the orders are for transactions on the securities companies' own account or those on their customers' accounts.

2. Strengthening and upgrading internal controls to ensure compliance with laws

(1) Establishment of rules concerning internal control systems in response to the revision to the SEL

A bill proposing partial revision to the SEL was submitted to the 142nd Diet Session. Specifically, in the bill it was stipulated that the JSDA has to clarify in its Articles of Association that it tries to prevent violations of laws by member companies and retain the trust of investors by making the member companies set up internal control rules and systems.

(2) Review of internal inspection and surveillance systems

[1] Securities companies are obliged to set up internal inspection rules, etc. to ensure that certain customers' accounts and transactions under the control of their head offices are not exempted from their internal inspections, internal surveillance, and internal control systems.

[2] The introduction of new systems was demanded that allow relevant directors and employees to report to the internal control divisions if instructions from senior directors and employees are suspected of violating laws.

(3) Clarification of responsibilities of assistant internal control supervisors

[1] In order to clarify the separation of duties, assistant internal control supervisors are obliged to report to internal control supervisors on the status of enforcement of their appointed duties.

[2] Besides the recommendation for the replacement of internal control supervisors, the JSDA came to be empowered to make a recommendation for the replacement of assistant internal control supervisors of the Association's member companies when they have not been fulfilling their duties properly.

I. Outline

1. Significance of market surveillance

In addition to inspections and investigations related to violations, the SESC conducts market surveillance as part of its regular surveillance activities. The objective of market surveillance is to ensure the fairness of securities transactions and the protection of investors. These activities 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 SESC conducts day-to-day monitoring of market activities by requesting detailed reports about securities transactions from securities companies and collecting relevant materials for market surveillance.

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 the authority by itself.)

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

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

2. Viewpoint and emphasis of market surveillance

Market surveillance focuses on the following points:

- (1) Stocks experiencing sharp price rises and drops
- (2) Stabilized stock price movements for certain periods
- (3) Stock price movements before and after cross-transactions
- (4) Stocks for which information appeared that significantly influenced the decisions of investors
- (5) Information provided by the general public

The following points are emphasized in market surveillance:

- (1) The involvement of securities companies, etc., which have heavier responsibilities as intermediaries than investors have in general
- (2) Whether the transactions in question violate laws and regulations, such as the SEL
- (3) Whether the market surveillance functions of SROs are working effectively

The SESC also maintains close relationships with the market surveillance sections of SROs, including stock exchanges and the JSDA, by exchanging necessary information on a regular basis or upon request, or making references to factual information.

If market surveillance reveals problems that necessitate closer investigation, the SESC endeavors to clarify such problems through such activities as on-site inspections.

II. Status of Market Surveillance

1. Number of cases

Market surveillance activities include gathering information on the market and enterprises, collecting materials from securities companies, and conducting hearings. Through these activities, closer surveillance of specific market transactions is conducted for certain periods.

During the year under review, cases of detailed market surveillance were as follows:

<i>Related to market manipulation</i>	124 cases
Sharp stock price rises	73 cases
Sharp stock price declines	27 cases
Stabilized stock price movements	15 cases
<i>Related to insider trading</i>	59 cases
Mergers	11 cases
New share issues	11 cases
Application for the commencement of corporate reorganization proceedings	9 cases
<i>Other, including spreading of rumors</i>	20 cases

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

Conducted by the SESC	112 cases
Conducted by regional finance bureaus	91 cases

2. Summary of surveillance results

The results of market surveillance conducted during the year can be summarized as follows:

Surveillance concerning market manipulation centered on sudden stock price rises or declines and on other unnatural movements, as well as on cases where stock prices were deemed to be maintained at fixed levels.

Stocks under surveillance for having experienced sudden price rises included stocks that were traded by certain groups of investors in a disguised and collaborative manner with the intention of raising stock prices. Stocks under surveillance for having experienced sudden price declines included stocks that were deemed to have been sold in response to other companies' bankruptcy.

Surveillance concerning insider trading focused on cases in which stock prices fluctuated significantly

upon the announcement of information thought to have a considerable impact on the decisions of investors.

These included numerous instances in which issuers of stocks announced information that would cause price declines, namely, announcements about the application for the commencement of corporate reorganization proceedings, downward revisions of expected business results, delisting, and failure to honor bills. Cases concerning suspicion of insider trading involved companies and their directors and employees dealing with the issuers, in addition to directors and employees of the issuers.

Surveillance concerning the spreading of rumors centered on issues whose prices fluctuated significantly owing to various types of information. The information included numerous stories about unstable corporate management. Such information was mainly conveyed by word of mouth, via "Dial Q2" telephone services, or over the Internet.

Regular securities market surveillance through these activities is considered to function as a direct or indirect deterrent to unfair transactions.

I. Receiving Information from the General Public

1. Information receiving system

Information provided by telephone, visit, or letter from the general public is useful for inspections, market surveillance activities, and investigations of criminal offenses. The SESC has therefore established a system for receiving such information and has been actively seeking information from the general public.

2. Status of information receipt

In the year under review, the SESC received 341 pieces of information from investors, etc., namely, 145 telephone calls, 107 letters, 45 visits, and 44 messages forwarded from the Securities Bureau of the Ministry of Finance and regional finance bureaus.

By type of information, 181 pieces were related to specific issues, 109 pieces were related to sales practices of securities companies, and 51 pieces were opinions, etc. directed to the SESC.

Out of the information related to specific issues, information concerning suspected market manipulation was most frequently seen. This was followed by the information concerning suspected insider trading and suspected loss guarantees and compensation.

Cases of transactions without customers' consent and solicitation with definitive predictions are increasingly becoming common among information concerning sales practices of securities companies (see Table 3).

Information received is passed to, and used by, sections conducting inspections, market surveillance, and investigations of criminal offenses, and by regional finance bureaus. From such information, the SESC obtained suggestions of items to be checked in inspections of securities companies. In other cases, the information was effective for market surveillance.

When concrete resolutions of problems between securities companies and investors are requested, the SESC on occasion refers matters to the Office of Consultation of the JSDA, where a system of complaint management has been established.

II. Cooperation with Overseas Regulatory Authorities

Along with the internationalization of securities transactions, cross-border misconduct affecting fairness in markets around the world has been occurring. As a result, international cooperation in the field of law enforcement has become increasingly important to ensure fairness in domestic markets.

Table 3: Status of Information Received

<i>Category</i>		<i>Jul. 7 to Aug. 6</i>	<i>Aug. 7 to Sep. 6</i>	<i>Sep. 7 to Oct. 6</i>
No. of items		368	255	341
Method of receipt	Telephone calls	180	120	145
	Visits	27	18	45
	Letters	123	82	107
	Forwarded information	38	35	44
Information content	Specific issues	176	111	181
	Suspected market manipulation	113	34	63
	Suspected insider trading	17	27	32
	Suspected loss guarantees and compensation	16	20	15
	Submission of falsified securities reports	13	8	15
	Other (spreading of rumors, etc.)	17	22	56
	Sales practices of securities companies, etc.	122	113	109
	Transactions without customers' consent	22	27	29
	Solicitation with definitive predictions	17	15	10
	Solicitation taking advantage of customers' lack of knowledge	16	6	3
	Conducting discretionary transactions	3	6	4
	Large-volume recommendation sale	2	4	1
	Other	62	55	62
	Opinions, etc. directed to the SESC	70	31	51

Taking this situation into consideration, the SESC continued to actively promote international exchange in the year under review, such as exchanging opinions with various overseas securities regulatory authorities regarding law enforcement. In the future, the SESC will continue to focus on promoting international coopera-

tion to prepare for the internationalization of securities markets through the Financial System Reform.

1. International Organization of Securities Commissions (IOSCO)

IOSCO is an international forum that promotes inter-

national harmony in securities regulations and cooperation among securities regulatory authorities. As of May 1998, 152 institutions from 91 countries, provinces, and regions around the world have membership in IOSCO.

In October 1993, the SESC joined IOSCO and has since participated in annual conferences every year. In November 1997, the SESC participated in the IOSCO's 22nd annual conference, held in Taipei.

Furthermore, the SESC is a member of a special committee of IOSCO that studies and proposes practical solutions for major regulation-related problems facing the global securities market. As a member of this committee, the SESC participates in deliberations concerning issues of enforcement and information exchange. Major recent topics of discussion include cooperation among regulatory authorities of various countries and the provision of information to address international securities-related crimes, and to this end the SESC actively participates in deliberations to address the internationalization of securities markets.

2. Asia-Pacific Directors of Enforcement Conference

The necessity to reinforce links among securities regu-

latory authorities in the Asia-Pacific region, which includes such important securities markets as Tokyo, Singapore, and Hong Kong, is growing. In the context of law enforcement, the furthering of mutual understanding of common interests among countries in the region is also gaining significance.

In this environment, as the first step in promoting cooperation the Asia-Pacific Directors of Enforcement Conference has been set up with representations from 12 countries in the region. The most recent conference was held in Mumbai, India, in February 1998. The SESC, as a participant in these conferences, endeavors to promote mutual understanding by explaining the status of surveillance systems in Japan.

III. Strengthening Surveillance Systems

1. Upgrading organization

Since its establishment, the SESC has worked hard to upgrade and reinforce its organization in order to implement more in-depth inspections and investigations. In the year under review, the addition of 15 investigators for Securities and Exchange was approved, allowing the SESC to upgrade and reinforce its criminal investigation system.

2. Development of a Comprehensive Securities System

In line with rapid advances in deregulation and internationalization of financial and capital markets, the business scope of securities companies is expanding and becoming more advanced and complex. At the same time, factors affecting risk management are changing significantly.

These circumstances underscore the urgency of building computer-based back-up systems to help upgrade securities company inspection and market surveillance. Since SESC year 1993, the SESC has been developing its Comprehensive Securities System, which can be broadly utilized for securities company inspection and market surveillance.

The Comprehensive Securities System is divided into two systems: the Securities Company Inspection System and the Market Surveillance System.

The Securities Company Inspection System assembles all kinds of financial data concerning securities companies and uses computers to automatically produce a register that makes a comparison of companies, thus raising the efficiency of inspections. This system

has been in operation since SESC year 1995.

The Market Surveillance System makes it possible, in the course of conducting surveillance of insider trading, market manipulation, and other activities, to make a quick and comprehensive reference to listed issues and OTC issues showing unnatural price movements, as well as the content of announcements of important incidents, thus enhancing the efficiency of surveillance. The system began operation in April 1997.

In SESC year 1997, the SESC completed the development of two new systems. One system automatically charts securities transactions, including names of customers. The other system charts sell and purchase orders at the time of the completion of a transaction. Both systems came into operation in October 1997.

The SESC regards the Comprehensive Securities System as extremely beneficial for conducting market surveillance. To raise the efficiency of inspection, surveillance, and other activities in the future, the SESC will promote the development of systems that allow more in-depth analyses.