

## Message from the Chairperson

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Chairperson : Ginko SATO

The Securities and Exchange Surveillance Commission (SESC) was established on July 20, 1992 as an independent agency. Our mission is to ensure fair transactions in the securities and financial futures markets, thus maintaining the confidence of investors in these markets.

At the time of its establishment, there were growing calls for:

- 1) converting securities policies to non-discretionary, ex-post-facto surveillance based policies based upon more transparent rules
- 2) separating the role of surveillance from that of supervising securities companies

In order to accomplish these purposes, the SESC was established as an independent agency and given statutory powers to carry out inspections of securities companies, daily market surveillance, and investigations of criminal offenses.

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Recently, an environment surrounding both securities regulator and market in Japan has changed considerably.

First, as a result of change in regulatory framework, an integrated financial regulator, called the Financial Services Agency (FSA), was newly established on July 1, 2000 and the FSA became a parental body of the SESC, while the SESC maintains its independence in exercising its powers. Not only regulator but also self-regulatory organizations in Japan experienced significant changes such as follows:

- A couple of "new markets" for start-up companies to raise capital were established. Among them are the "Mothers" market established in the Tokyo Stock Exchange (TSE) in November 1999 and the Nasdaq Japan established in the Osaka Securities Exchange (OSE) in May 2000. Those markets were opened amid the intensifying competition among markets partly caused by the appearance of proprietary trading systems (PTSs) in Japan.
- Securities and Exchange Law (SEL) has been amended to allow securities exchanges to demutualize their organization for faster decision making and more flexible fund raising in order to cope with the intensifying competition.

Second, securities market is experiencing the following changes in line with the drastic reform of Japan's financial system:

- shift from the licensing system to the registration system for securities companies was implemented in December 1998
- obligation to concentrate trading on the exchange was abolished in December 1998
- liberalization of brokerage commissions was implemented in October 1999
- restrictions on the business scope of the securities subsidiaries of banks was also abolished in October 1999.

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Moreover, trading via the Internet has been increasing in line with the rapid progress in information technologies.

In the midst of above mentioned changes, we are facing unprecedented types of illegal activities, such as solicitation of "tobashi"-like financial products that incorporate complicated derivatives instruments to defer realizing losses, and the use of deceptive devices in offering securities. Therefore, transactions subject to the SESC inspections and investigations have become complicated and widen, and our role to ensure fair and transparent securities transactions is getting greater.

The SESC intends to exercise its authority to the maximum extent to ensure fair securities transactions and protect investors. I sincerely hope that this report would enhance public understanding of the SESC and its activities in the markets.

佐藤ギン子

Ginko SATO

*Chairperson*

*Securities and Exchange Surveillance Commission*

## Summary

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The following is a summary of the main activities in SESC year 1999 (July 1, 1999 to June 30, 2000)

### **1. Investigations of criminal offenses**

In order to ensure fair markets, it is important to build investors' confidence that markets are closely watched by the authorities. Such confidence can be built by strict enforcement of the related laws and regulations. From this perspective, the investigation of criminal offenses is regarded as one of the most essential duties of the SESC.

During the year under review, compulsory investigations (searches of the premises of suspects and seizure of related evidence) were conducted against the Nippon Credit Bank, Ltd. on suspected submission of securities reports containing false information, against Cresvale International Limited on suspected sales of securities using a deceptive device, against transactions of Hunet Inc.'s shares on suspected market manipulation, and against transactions of Picoi Co., Ltd.'s shares on suspected insider trading. The SESC made a total of seven accusations to public prosecutors against violations of the SEL - one case of insider trading, one case of market manipulation, two cases of sales of securities using a deceptive device, and three cases of submission of securities reports containing false information.

In the eight years since its establishment, the SESC has made a total of 31 accusations - 11 cases of insider trading, seven cases of loss compensation, two cases of spreading rumors, three cases of market manipulation, six cases of submission of securities reports containing false information, and two cases of sales of securities using a deceptive device.

### **2. Inspection of securities companies**

Law compliance by securities companies is required as the first step in ensuring fair securities transactions in the markets as a whole. The SESC inspects the realities of compliance with transaction rules by securities companies. During the year under review, inspections were

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commenced on 86 domestic or foreign securities companies, and problems were found in and reported to 80 out of 94 companies in which inspections were completed.

The SESC inspections uncovered numerous cases of violations of laws, including discretionary trading account transaction and provision of property benefits for loss compensation, as well as a series of transactions to manipulate stock prices, securities transactions for speculative profits by directors and employees of securities companies, and solicitation with promises of special profits. These are deemed to be caused by a lack of awareness of the importance to comply with laws among directors and employees of securities companies, as well as insufficient internal control systems in securities companies. 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 a result of its inspections, the SESC sent recommendations (see Chapter 3) to the FRC and the Commissioner of the Financial Supervisory Agency (FSA) for administrative disciplinary actions in 37 cases - against 20 securities companies and 70 directors and employees of securities companies - for their grave violations of laws.

### **3. Effective market surveillance**

Effective collection and accurate analysis of information on the securities markets is essential in order to enable the timely detection of unfair transactions. To this end, the SESC strives for close cooperation with self-regulatory organizations (SROs) and collection of information from the general public in addition to checking the movements of stock prices.

In the year under review, the SESC conducted surveillance activities in a total of 326 cases - 78 cases of suspected price manipulation, 236 cases of suspected insider trading, and 12 cases of suspected spreading rumors and other matters.

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#### **4. Measures to cope with the progress of information technologies and internationalization**

The progress of information technologies has rapidly diversified and complicated financial products, and as symbolized by the Internet, it has had a significant impact on transaction methods and communication media. In order to cope with these situations, the SESC introduced the Securities Comprehensive Analyzing System (SCAN-System) in 1993 to enhance its analysis and search function in securities company inspections and market surveillance. And in May 2000, the Internet Patrol System (IPS) was introduced to efficiently collect and analyze information on the Internet.

As a result of increasing securities transactions across borders, exchanges of information with overseas regulators are getting essential in many cases. The SESC has been striving to strengthen cooperation with overseas regulators on various occasions of the International Organization of Securities Commissions (IOSCO) and trying to conclude Memoranda of Understanding (MOUs) aimed at exchanging non-public information on a bilateral basis.

## **Section 1. Outline**

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### **1. Purpose and history**

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

Investigations of criminal offenses are carried out by the SESC staff under their peculiar authority stipulated in the SEL, the Law on Foreign Securities Firms (LFSF) and the Financial Futures Trading Law (FFTL). In contrast, inspections of securities companies and other related financial institutions are conducted under the authority delegated to the SESC by the FRC and the Commissioner of the FSA. Concerning the investigations of criminal offenses, the SESC's authority is not limited to securities companies but reaches all parties involved in securities transactions, including investors themselves.

The SESC may conduct non-compulsory investigations of criminal offenses (Article 210 of the SEL, Article 53 of the LFSF, and Article 106 of the FFTL), including making inquiries about suspects or related parties (hereinafter, suspects), inspection of materials in the possession of or left behind by suspects, and the confiscation of materials supplied or left behind by suspects. The SESC may also conduct compulsory investigations with warrants from judges (Article 211 of the SEL, Article 53 of the LFSF, and Article 107 of the FFTL). Such investigations include visiting and searching the premises of suspects and seizing related evidence.

### **2. Scope of criminal offenses and accusations**

The scope of criminal offenses is prescribed in the relevant Cabinet Orders (Article 45 of the SEL Enforcement Order, Article 23 of the LFSF Enforcement Order, and Article 14 of the FFTL Enforcement Order). Among them, there are loss compensation, spreading rumors, market

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manipulation, insider trading, and submission of securities reports containing false information.

The results of criminal investigations are reported to the SESC by its investigators (Article 223 of the SEL, Article 53 of the LFSF, and Article 119 of the FFTL). When convinced of a suspect's guilt, the SESC sends an accusation to a public prosecutors office, together with a list of evidence seized during its investigations (Article 226 of the SEL, Article 53 of the LFSF, and Article 122 of the FFTL).

## **Section 2. Investigations and accusations of criminal offenses**

### **1. Investigations of criminal offenses**

During the year under review, the SESC conducted compulsory investigations based on suspicion of submitting securities reports containing false information by the Nippon Credit Bank, Ltd., on suspicion of sales of securities using a deceptive device by Cresvale International Limited, Tokyo Branch (Cresvale), on suspicion of market manipulation concerning Hunet Inc.'s shares, and on suspicion of insider trading concerning Picoi Co., Ltd.'s shares. These investigations included visiting and searching the premises of the suspected companies and related parties, and the seizure of the related evidence. The SESC also exercised its authority to conduct non-compulsory investigations as deemed necessary.

### **2. Accusations**

Based on the results of investigations, the SESC sent a total of seven accusations to public prosecutors' offices concerning possible SEL violations - one case of insider trading, one case of market manipulation, two cases of securities sales using a deceptive device, and three cases of submitting false securities reports. These are summarized below:

#### **(Case 1: Submission of securities reports containing falsified information)**

On August 13, 1999, in relation to the case concerning the Nippon Credit Bank, Ltd. that

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regarding the submitted securities reports containing false information, the SESC sent an accusation against five suspected individuals and one suspected company to the Tokyo District Public Prosecutor's Office for offenses against the SEL (Article 197 (1), "Acts of submitting securities reports containing false information on important items").

The suspect A, the president of the Nippon Credit Bank, Ltd., two vice presidents, the suspect B and the suspect C, and two directors in collusion submitted securities reports containing false information on important items by reporting about 61.3 billion yen in unappropriated losses, about 159.2 billion yen less than the actual unappropriated losses of about 220.5 billion yen in the term ending March 1998, through such means as not properly making allowances for or writing off uncollectable loans.

*Note: On August 13, 1999, a prosecution against the suspect A, B, and C was brought to the Tokyo District Court. The case is pending public trial.*

### **(Case 2: Market manipulation)**

On December 3, 1999, in relation to the market manipulation case concerning Hunet Inc.'s shares, the SESC sent an accusation against two suspected individuals to the Yokohama District Public Prosecutors Office for offenses against the SEL (Article 159 1-1, 2-1 and 4, "Prohibited acts of market manipulation").

The suspect A, in collusion with another, engaged in market manipulation of the share price of Hunet Inc., listed on the OTC market, from January 31, 1997 to May 23 the same year, by using 8 accounts (including assumed names) and

- ① by repeatedly making wash sales with no intention to transfer the right represented by the shares with the aim of misleading other persons with respect to the state of trading by creating

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a misleading appearance of active trading , and

- ② by creating a misleading appearance of active trading, and by buying and selling listed securities with the aim of causing changes in the prices of listed securities on the securities market, in order to induce other persons to buy or sell. As a result, the stock price was raised from 411 yen to 500 yen

*Note: On December 6, 1999, a prosecution against the suspect A was brought to the Yokohama District Court. On May 19, 2000, the court handed down a sentence of a year and a half with a stay of execution of three years. The case was closed.*

**(Case 3: Submission of half-yearly securities reports containing falsified information)**

On December 27, 1999, in relation to the case concerning Yakult Honsha Co., Ltd. regarding the submission of half-yearly securities reports containing false information, the SESC sent an accusation against two suspected individuals and one suspected company to the Tokyo District Public Prosecutors Office for offenses against the SEL (Article 198 (4), "Acts of submitting half-yearly securities reports containing falsified information on important items").

The Suspect A, vice president of Yakult Honsha Co., Ltd., and the suspect B, chairman of Cresvale in collusion submitted half-yearly securities reports containing false information on important items by reporting about 4.8 billion yen in unappropriated profits in the half-year term ending in September 1997, despite actual unappropriated losses of about 4.7 billion yen, by treating the Princeton Notes that Yakult Honsha Co., Ltd. had purchased from Cresvale and that had already been redeemed as if they were still outstanding.

*Note: On December 28, 1999, a prosecution against the accused two individuals and the accused company was brought to the Tokyo District Court. The case is pending public trial.*

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**(Case 4: Submission of securities reports containing false information)**

On January 31, 2000, in relation to the case concerning Tescon Co.,Ltd. regarding the submission of securities reports containing false information, the SESC sent an accusation against four suspected individuals and one suspected company to the Yokohama District Public Prosecutor's Office for offenses against the SEL (Article 197 (1), "Acts of submitting securities reports containing falsified information on important items").

The suspect A, the president of Tescon Co., Ltd., and three directors in collusion submitted securities reports containing false information on important items by reporting about 970 million yen in unappropriated profits in the term ending May 1998, through such means as fictitious sales, despite the fact that the company had unappropriated losses of about 1.76 billion yen.

*Note: On June 8, 2000, a prosecution against the suspect A was brought to the Yokohama District Court. The case is pending public trial.*

**(Case 5: Sales of securities using a deceptive device)**

On March 21, 2000, in relation to the sales of Princeton Notes by Cresvale using a deceptive device, the SESC sent an accusation against two suspected individuals and one suspected company to the Tokyo District Public Prosecutors Office for offenses against the SEL (Article 158, "Prohibition of using a deceptive device").

The suspect A, a director of Cresvale, and the suspect B, head of the Capital Market Department at Cresvale, in collusion employed a deceptive device in selling Princeton Notes to customers on around June 4, 1998, by issuing materials stating that the Notes in question were "products approved by the authorities, "despite of the fact that they were not approved by the Ministry of Finance nor by the Bank of Japan.

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*Note: On March 22, 2000, a prosecution against the suspect A and B was brought to the Tokyo Summary Court. On the same day, the two accused individuals received a summary order from the court to pay a fine of 300, 000 yen and the case was closed.*

**(Case 6: Sales of securities using a deceptive device)**

On March 22, 2000, in relation to the sales of Princeton Notes by Cresvale using a deceptive device, the SESC sent an accusation against one suspected individual and one suspected company to the Tokyo District Public Prosecutors Office for offenses against the SEL (Article 158, "Prohibition of using a deceptive device").

The suspect A, chairman of Cresvale, employed a deceptive device in selling Princeton Notes to customers between early March 1998 and mid-May 1999, by explaining that "the primary investment philosophy for Princeton Notes is safety of customers' assets, "despite of the fact that he was aware by around February 1998 at the latest that the asset value of the Notes was overvalued in its monthly investment reports from Princeton Economics International Limited or that the Notes might not be redeemed before maturity as promised.

*Note: On March 22, 2000, a prosecution against the suspect A was brought to the Tokyo District Court. The case is pending public trial.*

**(Case 7: Insider trading)**

On May 26, 2000, in relation to the insider trading case concerning Picoi Co.,Ltd. (Picoi)'s shares, the SESC sent an accusation against one suspected individual to the Tokyo District Public Prosecutors Office for offenses against the SEL (Article 166 (3), "Prohibited acts of insiders").

The suspect A, on receiving notification from the head of the Niigata branch of a trading company

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selling materials to Picoi that Picoi had decided to file an application for commencement of composition procedures, sold 16,000 Picoi's shares he held for 4.58 million yen on October 5, 1999, prior to the official announcement of the decision, in order to avoid losses.

*Note: On May 26, 2000, a prosecution against the suspect A was brought to the Tokyo District Court. On July 19 of the same year, the court sentenced the suspect A to 8 years in prison with a stay of execution of 3 years and a fine of 1 million yen and an additional fine of about 4.49 million yen. The case was closed.*