

### Section 1. Outline

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The SESC conducts on-site inspections of securities companies and related organizations to supervise their compliance with laws and regulations to secure fairness in securities transactions. The SESC inspections were carried out under the authority delegated to the SESC by the FRC and the Commissioner of the FSA as prescribed in the SEL, LFSF and FFTL.

The objective of the SESC inspections is to protect the public interest and investors. The SESC inspections are expected to support the FRC and the Commissioner of the FSA in taking necessary measures and formulating policies concerning securities companies.

The following institutions are subject to the SESC inspections:

- ① Securities companies and their holding companies
- ② Financial institutions registered to provide securities services
- ③ Securities dealers associations
- ④ Stock exchanges
- ⑤ Branches of foreign securities companies and specified financial institutions
- ⑥ Financial futures exchanges and their members
- ⑦ Financial futures dealers
- ⑧ Financial futures associations

The scope of SESC inspections is regulated in Cabinet Orders (Article 38 of the SEL Enforcement Order and Article 20 of the LFSF Enforcement Order) and rules set by the FRC (Article 27. Related to FFTL). For example, the SESC is authorized to conduct inspections of suspected 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 profits, etc.), as well as such violations as profit guarantees and loss compensation, market manipulation, and insider trading.

### Section 2. Basic policy and plan for inspections

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

At the beginning of the SESC year, the basic policies and plans for inspections are made in order to ensure that all inspections by the SESC and those by regional offices are managed and conducted strategically.

In the basic policies for inspections, important inspection items and other basic matters are determined. The basic plans for inspections elucidate the number and types of securities companies that the SESC inspects in that year.

### Section 3. Results of inspections

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#### 1. Inspections of securities companies

During the year under review, the SESC and regional offices commenced inspections of 86 securities companies.

Of this total, the SESC commenced inspections of six domestic securities companies and 14 branches of foreign securities companies. Regional offices commenced inspections of 66 domestic securities companies.

Regarding inspections commenced during the year under review, inspections were completed on 64 domestic securities companies and 13 branches of foreign securities companies with the presentation of a Notice of Conclusion to the companies (see Table 1). In addition, inspections commenced in SESC year 1998 but not completed by June 30, 1999 were completed during the year under review. These included inspections of 17 domestic securities companies.

Following the SESC recommendations based on inspections concluded in SESC year 1999 (including those commenced in the previous year), the FRC and the Commissioner of the FSA took administrative disciplinary actions against 37 securities companies for their grave violations of laws

and regulations (see Chapter 3).

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

## 2. Inspections of financial futures dealers

In SESC year 1999, the SESC also conducted inspections of financial futures dealers.

**Table 1 : Inspection**

Category	SESC Year 1995	SESC Year 1996	SESC Year 1997	SESC Year 1998	SESC Year 1999
Securities companies	86	83	79	80	86
Domestic (SESC)	84 (9)	80	72	68	72
(Regional offices)	(75)				
Foreign (SESC)	2 (2)	3 (3)	7 (7)	12 (12)	14 (14)
(Regional offices)	(0)	(0)	(0)	(0)	(0)
Branch inspections	15	26	31	27	28
Registered financial institutions (SESC)	10 (0)	7 (0)	0 (0)	0 (0)	0 (0)
(Regional offices)	(10)	(7)	(0)	(0)	(0)
Financial futures dealers (SESC)	0 (0)	0 (0)	1 (0)	0 (0)	0 (0)
(Regional offices)	(0)	(0)	(1)	(0)	(0)
SROs (SESC)	0 (0)	0 (0)	1 (1)	0 (0)	0 (0)
(Regional offices)	(0)	(0)	(0)	(0)	(0)

- Notes :
1. The above figures are the number of inspections commenced.
  2. The category "Branch inspections" shows the number of inspections conducted only on branches.
  3. Before December 1998, registered financial institutions were "financial institutions licensed to provide securities business."

## Section 4. Results of securities companies inspections

Inspections of securities companies in the year under review were conducted mainly to examine their compliance with laws and rules, sales practices, including investment solicitations, and internal control systems. Another important focus was to confirm that problems found through previous inspections had been improved.

Among the 94 companies of which inspections were completed, problems were found in 80 companies. Out of the 80, inspections found violations of laws and rules in 72 companies. Inspections also revealed many problems related to securities companies' sales practices and internal control systems.

In the year under review, the SESC uncovered a particularly large number of grave violations of laws, for which the SESC made recommendations to the FRC and the Commissioner of the FSA. These are believed to have been caused by a lack of awareness among directors and employees of the importance to comply with laws and rules, 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, and that securities companies themselves build effective internal control systems.

As for problems related to the compliance with market rules, the SESC found violations of laws, such as the conclusion of discretionary trading account transaction contracts, securities transactions for speculative profit by directors or employees, as well as numerous instances of violation of self-regulatory rules. During the year under review, the SESC also uncovered illegal activities, such as solicitation with promises of special profits and use of deceptive practices in offering securities.

As for problems related to sales practices, there were cases where the profit of customers was substantially ignored and where an insincere or unfair act was conducted in solicitation. They included solicitations for switching investment trusts on maturity without explaining the availability of

a preferential treatment (reduction or exemption of commissions) for switching and solicitations for switching a foreign currency financial instrument to another financial instrument in the same foreign currency without explaining the existence of the switching system that entails no exchange cost. The SESC proposed that the Commissioner of the FSA would take necessary and appropriate measures to correct these sales practices. (see Chapter 4)

As for internal control systems, though securities companies adopted measures to strengthen their systems, such measures were not enough to do so. They included a case where persons in charge of supervising internal control were not carrying out their duties, a failure to report to administrative authorities violations of self-regulatory rules despite knowing the violations, a case where the reason to apply to the exchange for an approval of correction of erroneous transaction was not true, and a case where transaction for which the customer should take the blame was taken over on the company's account by the securities company official in charge of internal control. These examples illustrate the facts that their internal control systems were practiced only in an insufficient or inappropriate manner and thereby the systems were ineffective, and that persons involved in controlling such systems lacked the awareness of the importance of complying with the laws and regulations.

The following is a summary of the problems found during inspections completed in SESC year 1999, including those commenced in the previous SESC year.

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

● **Violations of laws that resulted in recommendations**

- ① Counter-bucketing and bucketing
- ② Submission of falsified transaction reports to customers and non-submission of transaction reports to customers
- ③ Conclusion of discretionary trading account transaction contracts

- ④ False reports on securities and other transactions
- ⑤ Solicitation with the promise of special profit
- ⑥ Continued securities transactions to realize market prices that do not reflect real factors and continued acceptance of securities transaction orders, knowing that such actions will have a manipulative effect on the market
- ⑦ Provision of property benefits to compensate for losses, or having a third party provide such gains
- ⑧ Provision of property benefits to add to profits
- ⑨ Insufficient internal control on securities transactions from the standpoint of preventing unfair trading on information concerning corporations which a securities company has obtained
- ⑩ Transactions with parent companies on conditions significantly different from usual transaction conditions
- ⑪ Underwriter's extension of credits in sales of securities
- ⑫ Use of a deceptive device in offering securities
- ⑬ Short-selling in violations of cabinet ordinance
- ⑭ Submission of false reports in response to submission order
- ⑮ Securities transactions for speculative profit by directors or employees of securities companies
- ⑯ Insider trading by directors

● **Violations of laws that did not result in recommendations**

- ⑰ Violations of the requirements to specify trading form beforehand concerning shares traded on market-make markets
- ⑱ Conclusion of discretionary trading account transaction contracts
- ⑲ Securities transactions based on special information obtained on the job

- ⑳ Purchase of securities by a primary underwriting securities company on its own account during stabilization period
- ㉑ Insufficient internal control of corporate information from the standpoint of preventing unfair transactions on the corporate information
- ㉒ Receiving non-public information concerning customers from parent companies, or providing such information to parent companies
- ㉓ Establishing offices or sharing electronic information in a way that would damage independence from parent banks

● **Violation of self-regulatory rules**

- ㉔ Failure to explain that the disclosure of information about a company whose stocks are listed abroad is not obliged under the SEL
- ㉕ Borrowing of customers' names by sales representatives
- ㉖ Acceptance of securities transaction orders under borrowed names from sales representatives
- ㉗ Acceptance of securities transaction orders by sales representatives under assumed names
- ㉘ Lending money to and borrowing money from customers by sales representatives
- ㉙ Advertisements by sales representatives without a responsible person's examination of the advertisements

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

- ① Switching investment trusts on maturity without explaining the availability of a preferential treatment for switching
- ② Inappropriate handling concerning switching a foreign currency financial instrument to

another financial instrument in the same foreign currency

- ③ Inappropriate sales practices of yen-redemption dual currency
- ④ Inappropriate solicitation for investment in specified shares

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

- ① Insufficient internal control systems and insufficient operation of internal control systems
- ② Insufficient awareness by directors and employees of the importance of compliance with the laws and regulations

As there are many violations of laws with regard to sales of foreign bonds, the SESC, based on its authority to collect reports pursuant to the SEL, conducted a "Survey on the Handling of Foreign Bonds, Foreign Securities Investment Trusts, and Foreign Securities Investment" on domestic and foreign securities companies and used the results in its inspections.

With regard to the violations of laws in "acts of solicitation with promises of special profits," the SESC prepared a document showing specific examples as well as its basic point of view concerning the applicability of laws, and provided it to the regional offices, the Japan Securities Dealers Association (JSDA), the TSE, and the OSE for use as references in their future inspections.

**Section 5. Results of financial futures dealers inspections**

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Inspections of financial futures dealers were conducted concerning their compliance with transaction rules and realities of sales practices in soliciting investment, etc. However, no specific problems were found in the inspections.