

Section 1. Outline

Based on the results of inspections and investigations of criminal offenses, the SESC may, as necessary, make proposals to the FRC, the Commissioner of the FSA and the Minister of Finance to ensure fairness of securities transactions (Article 32 of the FRCEL).

Proposals are designed to present the SESC's comprehensive analyses of the incidents found through its inspections and investigations and its view on how laws and self-regulatory rules should be amended, so that they will be reflected in various measures to be taken by the administration and SROs. Proposals to be made by the SESC are important materials for judgement when administrative departments prepare their policies.

Section 2. Proposals and measures taken based on the proposals

During the year under review, the SESC made proposals to the Minister of Finance concerning explanatory notes attached to financial statements of banks, etc. on the basis of the results of its investigations of criminal offenses, and to the Commissioner of the FSA concerning the sales practice of securities companies on the basis of the results of its inspections of securities companies.

1. Contents of proposals

- (1) Proposals concerning explanatory notes attached to financial statements of banks, etc.

As a result of its investigations of criminal offenses conducted pursuant to the provision of the SEL with regard to the false statement of securities reports of the Long-Term Credit Bank of Japan, Ltd. and the Nippon Credit Bank, Ltd., the SESC found problems with regard to financial statements submitted by banks. On December 21, 1999, the SESC proposed that the Minister of Finance take necessary and appropriate measures, such as amendment of related rules.

The problems pointed out in the proposal are as follows:

- ① Explanatory notes on assets offered as collateral

The Long-Term Credit Bank of Japan, Ltd. offered securities as collateral to provide credit enhancement to the debts of its non-bank affiliates. However, the bank did not write that information in its securities report.

"Regulations concerning terms, forms and preparation of financial statements" (hereinafter, "Regulations of Financial Statements") stipulated that when assets were offered as collateral, that information must be noted and explained. The regulations, however, said that explanatory notes on collateral assets were not required in the case of particular businesses, such banking and trust businesses.

From the standpoint of ensuring full protection of investors by promoting thorough disclosure of important financial information prerequisite for investment judgement, it was necessary to amend this kind of exceptional treatment and disclose assets offered as collateral by the banking and trust businesses.

- ② Thorough disclosure of trading with related parties

The Long-Term Credit Bank of Japan, Ltd. and the Nippon Credit Bank, Ltd. had various transactions with their respective non-bank affiliates, including abandonment of credit. But they failed to enter such transactions in their securities reports.

Since transactions between related parties are sometimes conducted under terms not normally seen in transactions between independent and equal partners, the Regulations of Financial Statements stipulate that the contents of transactions, terms of transactions, etc. with regard to important transactions between related parties must be noted and explained and that this requirement also applies to financial statements of the banking and trust businesses.

Therefore, it was necessary for the banking and trust businesses to disclose the transactions with related parties to the fullest extent without interpreting the provision narrowly in their accounting practice, so that investors could make appropriate judgements on the effects of transactions with related parties on their financial conditions and business performance.

(2) Proposals concerning sales practices of securities companies

As a result of its inspections of securities companies conducted in pursuant to the provision of the SEL, the SESC found problems with regard to sales practices of securities companies that were required to carry out businesses sincerely and fairly. On March 24, 2000, the SESC proposed that the Commissioner of the FSA take necessary and appropriate measures to protect investors by utilizing the self-regulatory function of the JSDA.

The problems pointed out in the proposal are as follows:

① Switching investment trusts on maturity without explaining the availability of a preferential treatment for switching

If investors reinvest the proceeds of a maturing securities investment trust in another securities investment trust offered in the same securities company within a specified period of time, a preferential treatment for the switching is available in the form of reduction or exemption of commissions. In its inspections of securities companies that were completed in and after March 1998, the SESC found that the preferential treatment option was not made use of in many securities companies as sales representatives failed to fully explain the existence of the treatment due to their lack of awareness of the treatment and consequently that customers had to pay unnecessary commissions.

The preferential treatment has not been made use of by many sales representatives in transactions with many customers for a long time in all or a large majority of sales offices of

securities companies inspected.

② Inappropriate handling of switching a foreign currency financial instrument to another in the same foreign currency

In its inspection of securities companies that were completed in and after November 1998, the SESC found that many securities companies charged unnecessary foreign exchange commissions to customers as sales representatives, due to their lack of awareness, failed to fully explain the disadvantage of converting into Japanese yen when switching a foreign currency financial instrument to another in the same foreign currency. In such switching transactions, customers had to first convert into the yen the proceeds from sales of a foreign currency financial instrument and then convert the yen into a foreign currency to purchase another foreign currency financial instrument in the same foreign currency.

2. Measures taken based on proposals

(1) Measures taken based on proposals concerning explanatory notes attached to financial statements of banks, etc.

In response to the SESC's proposal dated December 21, 1999, the Minister of Finance amended "Regulations of Financial Statements Guideline" in order to correct the point that does not require banking and trust businesses to submit explanatory notes on collateral assets in financial statements.

As to transactions between related parties, the scope of related parties was made clear in the "Important notice in preparation and submission of securities report (March 2000 edition)".

The Japanese Bankers Association and the Marine & Fire Insurance Association of Japan, Inc. sent a notice to their respective member companies to call to their attention the importance of explanatory notes on collateral assets and disclosure of transactions with related parties.

(2) Measures taken based on proposals concerning sales practices of securities companies

In response to the SESC's proposal dated March 24, 2000, the Commissioner of the FSA sent a notice on the same day to the chairman of the JSDA to take necessary and appropriate measures concerning the problem of sales practices of securities companies.

On March 29, 2000, the JSDA issued "Improper investment solicitation in switching securities investment trusts and foreign currency financial instruments" to its members and called on them to take the problem seriously and strive to make the problem thoroughly known to directors and employees.

The FSA made the measures taken by the JSDA known to Regional Finance Bureaus and the Investment Trusts Association, Japan.

Section 1. Outline

In addition to inspections and investigations related to violations, the SESC conducts market surveillance as part of its regular 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 FRC and the Commissioner of the FSA as prescribed in the SEL, LFSF, and FFTL. The SESC conducts day-to-day monitoring of market activities by requesting detailed reports on securities transactions from securities companies and collecting relevant materials for market surveillance.

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

- 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 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.

Section 2. Market surveillance

1. Market surveillance

Market surveillance activities include gathering information on the markets and companies,

collecting materials from securities companies, and conducting hearings. Through these activities, close analysis of specific market transactions is conducted for certain periods.

Details of market surveillance conducted during the year under review were as follows:

| | |
|--|-----------|
| (1) Related to market manipulation | 78 cases |
| • Sharp stock price rises | 68 cases |
| • Pegged stock price movements | 5 cases |
| (2) Related to insider trading | 236 cases |
| • Stock splits | 41 cases |
| • New share issues | 38 cases |
| • Upward revision of earnings estimate | 24 cases |
| (3) Others, including spreading rumors | 12 cases |

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

| | |
|-------------------------------|-----------|
| Conducted by the SESC | 227 cases |
| Conducted by regional offices | 99 cases |

2. Summary of surveillance results

The results of market surveillance conducted during the year under review can be summarized as stated below:

Surveillance concerning market manipulation centered on sudden stock price rises and on other unnatural movements, as well as on cases where stock prices were deemed to be maintained at fixed levels. Stock under surveillance for having experienced sudden price rises included stocks that seemed to be traded by certain groups of investors in a disguised and collaborative manner with the intention of raising stock prices.

Surveillance concerning insider trading focused on cases in which stock prices fluctuated significantly upon the announcement of information that seemed to have a considerable impact on

the decisions of investors. These included a considerable amount of information that would cause price rises, such as the announcement of stock splits, new stock issues and upward revisions of earnings estimates. Cases concerning the suspicion of insider trading involved the directors and employees of the companies that have business relationship with issuers, in addition to the directors and employees of the issuers.

Surveillance concerning spreading rumors centered on stocks whose prices fluctuated significantly owing to various types of information.

Cases that required further investigation would be dealt with by conducting on-sight inspections, etc.

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

Section 1. Measures for Internet trading

1. Outline

With the rapid development of information technology in recent years, the number of Internet users in Japan has increased dramatically and an enormous number of websites have been created. The Internet is becoming a new means of information transmission.

And the increase in the use of the Internet in securities transactions, which was prompted partly by the liberalization of brokerage commissions, has increased the importance of market surveillance of unfair trading that use the Internet.

In response to the changing environment surrounding securities transactions, the SESC has positioned its staff in charge of day-to-day collection and analysis of various pieces of information that are posted on bulletin boards or homepages of the Internet. The SESC also inspects securities companies to grasp the reality of Internet trading.

2. Internet Surf Day

The Internet causes dramatic change in securities markets, makes it easier for investors to obtain more information. On the other hand, the Internet creates new methods for illegal activities in securities markets. Since the Internet can transmit information throughout the world instantaneously, the monitoring of securities transactions via the Internet by one country is inadequate. International cooperation in surveillance activities is necessary.

In recognition of the importance of such international cooperation, 21 securities and futures regulators from 18 countries among the members of IOSCO coordinated their efforts on March 28, 2000 in order to simultaneously identify illegal securities and futures activities on the Internet.

A total of about 10,000 sites on the Internet in the 18 countries were surveyed and the regulators had agreed to follow up more than 1,000 sites, including more than 250 sites involving cross-border activity. The SESC surveyed 336 sites on the Internet and reported to the IOSCO that it would

follow up 25 sites, including nine sites involving cross-border activity.

3. Internet Patrol System

There is increasing possibility of false information designed for market manipulation being circulated via the Internet.

Since it is difficult for the SESC to check such information with a limited number of staff, the SESC has developed the IPS for efficient surveillance.

The system conducts automatic and regular patrol of specified websites to collect and accumulate information and permits retrieval of information on specified issues as need arises. By using the system the SESC has increased the efficiency of its collection of information on websites that are updated and expanding on a daily basis.

Section 2. Measures for new markets

On November 11, 1999, the "Mothers" market opened in the TSE and trading in two stocks began on December 22 of the same year (16 stocks as of August 31, 2000). And on May 8, 2000, the Nasdaq Japan was established in the OSE and trading in eight stocks began on June 19 of the same year (16 stocks as of August 31, 2000).

The creation of these new markets is designed to promote fostering new industries by facilitating fund raising by start-up companies and to provide diversified investment instruments to investors.

The SESC is striving to ensure the fairness of transactions in these new markets, as in existing markets, by conducting appropriate surveillance activities in close cooperation with securities exchanges and other related organizations.

Section 3. Information received from the general public

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

In the year under review, the SESC received 789 pieces of information from investors, and so forth, namely, 198 telephone calls, 19 visits, 156 letters, 359 messages via the Internet, and 57 pieces of information forwarded from the FSA and the regional offices. By type of information, 385 pieces were related to specific stocks, 200 pieces were related to the sales practices of securities companies, and 204 pieces were opinions directed to the SESC.

Out of the information related to specific stocks, information concerning suspected market manipulation was most frequently seen. This was followed by information concerning suspected insider trading and suspected spreading rumors.

Among information concerning the sales practices of securities companies, cases of solicitation by taking advantage of customers' lack of knowledge were most frequently seen. This was followed by cases of transactions without the customers' consent (see Table 2).

Information received is passed to, and used by, sections conducting inspections, market surveillance, investigations of criminal offenses, and regional offices.

Table 2 : Information Received (last 3 years)

Methods

| | 07/97-06/98 | 07/98-06/99 | 07/99-06/00 |
|---|-------------|-------------|-------------|
| Internet | - | 49 | 359 |
| Telephone calls | 145 | 77 | 198 |
| Letters | 107 | 55 | 156 |
| Visits | 45 | 21 | 19 |
| Information forwarded from the FSA and the regional offices | 44 | 39 | 57 |
| Total | 341 | 241 | 789 |

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| | 07/97-06/98 | 07/98-06/99 | 07/99-06/00 |
|---|-------------|-------------|-------------|
| Specific stocks | 181 | 147 | 385 |
| Suspected market manipulation | 63 | 51 | 162 |
| Suspected insider trading | 32 | 32 | 90 |
| Suspected submission of false securities reports | 15 | 11 | 39 |
| Suspected profit guarantee and loss compensation | 15 | 10 | 15 |
| Others (spreading rumors, etc.) | 56 | 43 | 79 |
| Sales practices of securities companies | 109 | 66 | 200 |
| Transactions without customers' consent | 29 | 15 | 16 |
| Solicitation with definitive predictions | 10 | 5 | 7 |
| Solicitation taking advantage of customers' lack of knowledge | 3 | 3 | 21 |
| Conducting discretionary transactions | 4 | 7 | 6 |
| Large-volume recommendation sale | 1 | 2 | 3 |
| Others | 62 | 34 | 147 |
| Others, including opinions, etc. directed to the SESC | 51 | 28 | 204 |
| Total | 341 | 241 | 789 |

Section 4. Cooperation with foreign 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.

Taking this situation into consideration, the SESC continued to actively promote international cooperation in the year under review, such as exchanging opinions with various foreign securities regulators regarding law enforcement.

1. Relationship and cooperation with foreign regulatory authorities

In order to promote the reform of Japan's securities markets and improve its surveillance system, it is necessary to understand the regulations in other countries. The SESC promotes exchanges of information on vital issues with foreign regulators on various occasions of IOSCO meetings held every year and through individual interviews at various levels.

Note: IOSCO is an international forum that promotes international harmonization in securities regulations and cooperation among securities regulators. As of June 2000, 165 institutions from 96 countries, provinces, and regions around the world have membership in IOSCO.

2. MOUs and exchange of law enforcement information

As a result of the internationalization of securities transactions, the need for information exchange with foreign regulators is increasing for the SESC's investigations of unfair trading practices. Because it is necessary for regulators in Japan to conclude MOUs in order to exchange non-public information with foreign regulators, the SESC has been working on the authorities concerned to positively promote the conclusion of MOUs with foreign regulators.

In addition, the SESC exchanges information with the other Asia-Pacific Regional Committee member countries according to the resolution adopted among the members in April 1997, which calls for exchange of information whenever a member country announced information on securities and exchange law violations relevant to other member countries. The SESC publishes the press releases of its recommendations on its website.

Section 5. Strengthening surveillance systems

Since 1993, the SESC has been developing its SCAN-System, which can be broadly utilized for securities company inspections, market surveillance, and investigations of criminal offenses.

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

(1) Securities Company Inspection System

This system assembles various kinds of financial data concerning securities companies and data concerning the outline of inspection results for the analyses of inspections of securities companies. This system has been in operation since 1995.

(2) Market Surveillance System

This system makes it possible, in the course of preparing basic data for conducting surveillance of insider trading, market manipulation, and other activities, to make a quick and comprehensive reference to listed or over-the-counter stocks showing unnatural price movements, as well as the content of announcements of important facts and the content of transactions. This system has been in operation since 1997.

The SESC has been continuing to develop the Systems in order to further improve their functions. In fiscal 1999, the SESC developed the IPS to monitor various pieces of information on the Internet.

The system has made it possible to search, retrieve and assemble information on specific stocks from among enormous amounts of information on the Internet.