

## Message from the Chairman

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Chairman : Takeo TAKAHASHI

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, thereby maintaining the confidence of investors in these markets.

Leading up to the time of our establishment, there were growing calls for

- 1) a change from securities policies to nondiscretionary, ex post facto surveillance-based policies based on more transparent rules
- 2) separating the surveillance and supervision of securities companies

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

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Recently, the environment surrounding both securities regulators and markets in Japan has changed considerably.

First, as a result of a change in the regulatory framework, an integrated financial regulator called the Financial Services Agency (FSA) was established on July 1, 2000. The FSA became the parental body of the SESC, but the SESC maintained its independence in exercising its power. Not only regulators but also self-regulatory organizations in Japan experienced significant changes. Two new markets were established for start-up companies to raise capital: Mothers, which was established by the Tokyo Stock Exchange (TSE) in November 1999, and NASDAQ Japan, which was established by the Osaka Securities Exchange (OSE) in May 2000. The two markets were opened amid intensifying market competition that was partly caused by the appearance of proprietary trading systems in Japan. As the Hiroshima Stock Exchange, Niigata Stock Exchange, and Kyoto Stock Exchange closed down, new challenges arose: the OSE changed from a mutual organization to a stock corporation.

Second, the securities market experienced the following as a result of a drastic reform of Japan's financial system:

- a shift from a licensing system to a registration system for securities companies in December 1998
- an end to the obligatory concentration of trading on the exchange in December 1998
- the liberalization of brokerage commissions in October 1999
- an end to restrictions on the business scope of the securities subsidiaries of banks in October 1999.

In the midst of the above mentioned changes, we are facing new forms of illegal activities. In

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the year under review, SESC inspections revealed illegal cases concerning new financial devices, such as exchangeable bonds, in the form of ① stock price manipulation to evade payment for bonus coupons, ② solicitations using false or misleading statements. Therefore, transactions subject to SESC inspection and investigation have become complicated and diverse. Therefore, our role to ensure fair and transparent securities transactions is getting bigger.

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.

高橋武生

Takeo TAKAHASHI

*Chairman*

*Securities and Exchange Surveillance Commission*

## Summary

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The following is a summary of the Securities and Exchange Surveillance Commission's (SESC's) main activities in SESC year 2000 (July 1, 2000, to June 30, 2001)

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

To ensure fairness in markets, it is important to build investors' confidence in the authorities' ability to closely watch those markets. Such confidence can be built by a strict enforcement of 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 (which included searching the suspect's premises and seizing related evidence) were conducted into transactions involving the shares of Totenko Co., Ltd. (Totenko) (suspected of spreading rumors, etc.), Aica Kogyo Company, Limited (Aica Kogyo) (suspected of market manipulation), and MUTOH INDUSTRIES LTD (MUTOH) (suspected of insider trading). The SESC filed a total of five complaints with public prosecutors against violations of the Securities and Exchange Law (SEL): two cases of insider trading, one case of market manipulation, one case of spreading rumors, and one case of failing to submit reports on large shareholders.

In the nine years since its establishment, the SESC has filed a total of 36 complaints: 13 cases of insider trading; seven cases of a loss of compensation; three cases of spreading rumors; four cases of market manipulation; six cases of submitting securities reports containing false information, etc.; two cases of selling securities using deception; and one case of failing to submit reports on large shareholders.

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

Compliance with the law by securities companies is the first step required in ensuring fair securities transactions in the markets as a whole. The SESC inspects securities companies for compliance with transaction rules. During the year under review, inspections commenced on 96

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domestic and foreign securities companies and three registered financial institutions. Problems were discovered, and reported, in 62 out of 97 companies in which inspections were completed.

SESC inspections uncovered numerous violations of laws, including discretionary trading account transactions, a series of transactions to manipulate stock prices, and solicitations with promises of special profits. SESC inspections also uncovered many problems concerning sales practices and the internal control systems of securities companies. These were deemed to be caused by a lack of awareness on the part of directors and employees of the importance of complying with laws of securities companies as well as insufficient internal control systems in securities companies. The directors and employees of securities companies must increase 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 prime minister (FRC) (before January 5, 2001) and the commissioner of the Financial Supervisory Agency (FSA, now the Financial Services Agency) on administrative disciplinary action against 18 securities companies and 47 directors and employees of securities companies in 34 cases for grave violations of the law.

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

The effective collection and accurate analysis of information on securities markets are essential in detecting unfair transactions quickly. To this end, the SESC strives to work closely with self-regulatory organizations (SROs) and collect information from the general public in addition to checking movements in stock prices.

In the year under review, the SESC conducted surveillance activities in a total of 265 cases: 62 cases of suspected price manipulation, 190 cases of suspected insider trading, and 13 cases of suspected spreading of rumors and other issues.

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

Information technology has rapidly diversified and complicated financial products and, as symbolized by the use of the Internet, has had a significant impact on transaction methods and communication media. To cope with this situation, the SESC enhanced its system of collecting and analyzing information on the Internet through the Internet Patrol System (IPS).

As a result of the rise in the number of securities transactions across borders, the sharing of information with overseas regulators has become essential in many cases. The SESC has been striving to increase cooperation with overseas regulators on various occasions presented by the International Organization of Securities Commissions (IOSCO) and trying to conclude memorandums of understanding (MOUs) aimed at sharing nonpublic information on a bilateral basis.

## **Chapter 1: Investigations of Criminal Offenses and Filing of Complaints**

### **Section 1. Outline**

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

The authority to investigate criminal offenses was given to the SESC at its establishment to ensure market fairness and soundness as well as to protect investors. With this authority, the SESC investigates any illegal action that violates laws and regulations and calls for criminal prosecution by filing formal complaints.

Investigations of criminal offenses are carried out by the SESC staff under the authority prescribed 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 prime minister 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 noncompulsory 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"), the inspection of materials in the possession of or left behind by suspects, and the confiscation of materials supplied to 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 filing of complaints**

The scope of criminal offenses is prescribed in 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), including loss compensation, the spreading of rumors, market manipulation,

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Insider trading, and the 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 files a complaint with a public prosecutors office and sends the evidence it gathered in its investigation (Article 226 of the SEL, Article 53 of the LFSF, and Article 122 of the FFTL).

## **Section 2. Investigations of criminal offenses and filing of complaints**

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

In the year under review, the SESC conducted compulsory investigations based on suspected spreading of rumors concerning Totenko shares, insider trading concerning MUTOH shares, and market manipulation concerning Aica Kogyo shares. These investigations included visiting and searching the premises of suspects and seizing related evidence. The SESC also exercised its authority to conduct noncompulsory investigations as deemed necessary.

### **2. Filing of complaints**

Based on the results of its investigations, the SESC filed a total of five complaints with public prosecutors offices concerning possible SEL violations: two cases of insider trading, one case of market manipulation, one case of spreading rumors, and one case of failing to submit reports on large shareholders. These cases are summarized below.

#### **(Case 1: Insider trading)**

On November 28, 2000, in relation to an insider trading case concerning the shares of PLENUS Co., Ltd.(PLENUS), the SESC filed a complaint with the Tokyo District Public Prosecutors Office against a suspected individual for violating the SEL (Article 166 (3), "Prohibited acts of insiders").



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The suspect A, on receiving notification from the director of PLENUS that PLENUS had decided to buy 82% of The Daiei Inc.'s HOKKAHOKKATEI Co., Ltd. shares, bought 1,000 shares of PLENUS for ¥2.39 million on March 25, 1999, prior to the official announcement of the decision, in order to gain profit.

*Note: On November 28, 2000, a prosecution against the suspect A was brought to the Tokyo Summary Court. On the same day, she received a summary order from the court to pay a fine of ¥0.5 million and an additional fine of approximately ¥1.58 million. The case was closed.*

**(Case 2: Spreading rumors and submitting reports on large shareholders containing falsified information)**

On December 4, 2000, in relation to a case of rumors being spread and the submission of reports on large shareholders containing false information concerning Totenko shares, the SESC filed a complaint with the Tokyo District Public Prosecutors Office against four suspected individuals for violating the SEL (Article 158, "Prohibition of spreading rumors, "and Article 27 (23) (i), "Acts of submitting reports on large shareholders containing false information on important items").

On February 17, 2000, the suspect A, in collusion with the suspect B and two others, spread rumors in order to manipulate the market. The accused sent information to the Kabuto Club of the Tokyo Stock Exchange (TSE) indicating that the suspect B had decided to organize a takeover bid for Totenko because he thought the company neglected its shareholders, a conclusion brought about by the fact that the executives of the company would not meet with him when he visited Totenko, even after buying 5,238,000 of its shares.

On February 2, 2000, the suspect A, in collusion with the suspect B, submitted a securities report on large shareholders containing false information on important items by reporting that

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the suspect B had bought 5,238,000 Totenko shares.

*Note: On December 4, 2000, a prosecution against the four accused individuals was brought to court. The suspect B, C (or D), and E received a summary order from the Tokyo Summary Court to pay a fine of ¥0.5 million. The case against the suspect A is pending public trial in the Tokyo District Court.*

**(Case 3: Failure to submit reports on large shareholders)**

On December 4, 2000, the SESC filed a complaint with the Tokyo District Public Prosecutors Office against a suspected individual for violating the SEL (Article 27 (23) (i), "Failure to submit reports on large shareholders").

Although the suspect A had bought up to 1,295,000 Totenko shares-which were more than 5/100 of the company's outstanding shares-from September 1997 to February 1998, he did not submit a report on large shareholders to the Kinki Regional Finance Bureau by the deadline.

*Note: On December 4, 2000, a prosecution was brought against the suspect A (in addition to Case 2 mentioned above) to the Tokyo District Court. The case is pending public trial.*

**(Case 4: Insider trading)**

On March 12, 2001, in relation to an insider trading case concerning MUTOH shares, the SESC filed a complaint with the Tokyo District Public Prosecutors Office against a suspected individual for violating the SEL (Article 166 (1), "Prohibited acts of insiders").

In around July 2000, the suspect A, working on business acquisitions as a counselor of the Strategic Planning Office of Tokyo Computer Service Co., Ltd. (Tokyo Computer Service),

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received notification that MUTOH had decided to collaborate with Tokyo Computer Service and increase its capital by private placement to Tokyo Computer Service. Based on this information, the suspect A bought up to 42,000 MUTOH shares for ¥9.20 million from July 21 to 23, 2000, prior to the official announcement of the decision, in order to gain profit.

*Note: On March 12, 2001, a prosecution against the suspect A was brought to the Tokyo District Court. On May 29, 2001, the court sentenced the suspect A to one year in prison with a stay of execution of three years and a fine of ¥1 million and an additional fine of approximately ¥14.14 million. The case was closed.*

**(Case 5: Market manipulation)**

On April 27, 2001, in relation to a market manipulation case concerning Aica Kogyo shares, the SESC filed a complaint with the Nagoya District Public Prosecutors Office against a suspected individual for violating the SEL (Article 159, "Prohibited acts of market manipulation).

The suspect A manipulated the price of Aica Kogyo shares from December 15, 1999, to January 17, 2000, by using several accounts to

- ① create the appearance of active trading and by buying and selling listed securities with the aim of causing changes in their prices in order to induce others to buy or sell. As a result, the price of Aica Kogyo shares rose from ¥606 to ¥680.
- ② repeatedly make wash sales with no intention of transferring the right represented by the shares with the aim of creating the appearance of active trading.

*Note: On May 2, 2001, a prosecution against the suspect A was brought to the Nagoya District Court. The case is pending public trial.*