

## Chapter 2: Inspections

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### Section 1. Outline

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The SESC conducts on-site inspections of securities companies and related organizations to confirm their compliance with laws and regulations and ensure fairness in securities transactions. SESC inspections are carried out under the authority delegated to the SESC by the prime minister and the commissioner of the FSA as prescribed in the SEL, LFSF and FFTL.

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

The following institutions are subject to SESC inspections:

- ① Securities companies and their holding companies
- ② Registered financial institutions that 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 (FFAs)

The scope of SESC inspections is regulated by the Cabinet Orders (Article 38 of the SEL Enforcement Order, Article 20 of the LFSF Enforcement Order, and Article 9 of the FFTL Enforcement Order). For example, the SESC is authorized to conduct inspections on the suspicion of violations of laws and regulations, including discretionary trading account transactions, solicitations with definitive predictions, and solicitations with promises of special profits, by securities companies and their directors or employees as well as such violations as profit guarantees and loss compensation, market manipulation, and insider trading.

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

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Inspection periods are based on SESC years (from July 1 to June 30 of the following year).

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

Important inspection items and other basic matters are determined in the basic policy for inspections. The basic plan for inspections states the number and types of securities companies that the SESC is to inspect 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 the inspection of 96 securities companies and three registered financial institutions.

Of this total, the SESC commenced the inspection of nine domestic securities companies, 14 branches of foreign securities companies, and two registered financial institutions. Regional offices commenced the inspection of 73 domestic securities companies and one registered financial institution.

Regarding inspections that were commenced during the year under review, inspections were completed on 73 domestic securities companies, 13 branches of foreign securities companies and two registered financial institutions with the presentation of a Notice of Conclusion to the companies (see Table 1). In addition, inspections that were commenced in SESC year 1999 but were not completed by June 30, 2000, were completed during the year under review. These included the inspection of nine domestic securities companies.

Following SESC recommendations based on inspections concluded in SESC year 2000

(including those that were commenced in the previous year), the prime minister and the commissioner of the FSA took administrative disciplinary actions against 33 securities companies for their grave violations of laws and regulations (see Chapter 3).

Problems uncovered in 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 2000, the SESC conducted inspections of financial futures dealers along with these of securities companies.

**Table 1 : Inspection**

Category	SESC Year 1996	SESC Year 1997	SESC Year 1998	SESC Year 1999	SESC Year 2000
Securities companies	83	79	80	86	96
Domestic	80	72	68	72	82
(SESC)	(12)	(7)	(6)	(6)	(9)
(Regional offices)	(68)	(65)	(62)	(66)	(73)
Foreign	3	7	12	14	14
(SESC)	(3)	(0)	(12)	(14)	(14)
(Regional offices)	(0)	(0)	(0)	(0)	(0)
Branch inspections	26	31	27	28	27
Registered financial institutions	7	0	0	0	3
(SESC)	(0)	(0)	(0)	(0)	(2)
(Regional offices)	(7)	(0)	(0)	(0)	(1)
Financial futures dealers	0	1	0	0	0
(SESC)	(0)	(0)	(0)	(0)	(0)
(Regional offices)	(0)	(1)	(0)	(0)	(0)
SROs	0	1	0	0	0
(SESC)	(0)	(1)	(0)	(0)	(0)
(Regional offices)	(0)	(0)	(0)	(0)	(0)

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- 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 inspections of securities companies**

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

Among the 97 companies that were inspected, problems were uncovered in 62 companies. Out of the 62, inspections uncovered violations of laws and rules in 53 companies. Inspections also revealed many problems related to the sales practices and internal control systems of securities companies.

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 prime minister 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 compliance with market rules, the SESC uncovered violations of laws, such as conclusions of discretionary trading account transaction contracts, securities transactions for speculative profit by directors or employees, and numerous instances of violations of self-regulatory rules. During the year under review, the SESC also uncovered vicious illegal activities, such as the giving of false or misleading information related to securities and other trading, the

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acceptance of securities transaction orders with the knowledge that such actions will have a manipulative effect on the market, and solicitations with promises of special profits.

As for problems related to sales practices, there were cases in which the customer's profit was substantially ignored and insincere or unfair acts were conducted in solicitations. They included solicitations of switching investments from dual currency bonds to other financial instruments, slighting the investor's interest; inappropriate sales practices in offering securities; solicitations for switching investment trusts on maturity without explaining the availability of preferential treatment (reduction or exemption of commissions) for switching. The SESC proposed that the commissioner of the FSA take necessary and appropriate measures to correct these sales practices (see Chapter 4).

As for internal control systems, although securities companies adopted measures to strengthen their systems, such measures were not enough to do so. They included a case in which violations of self-regulated rules occurred continuously because appropriate measures were not taken to prevent the recurrence of the violations despite being aware that the violations occurred before; a case in which violations of laws and regulations were overlooked for a long time because of inappropriate inspections by the person in charge of internal control; a case in which the president and representative director were engaged in illegal transactions and ignored the advice of the person in charge of internal control to cancel the transactions; and a case in which a securities company withdrew its accident report, which referred to the company's illegal or wrongful act, without a sufficient investigation of the accident. These examples illustrate the fact that the internal control systems of these companies were carried out in an insufficient or inappropriate manner, thereby making the systems ineffective, and that the people involved in controlling these systems lacked the awareness of the importance of complying with laws and regulations.

The following is a summary of the problems uncovered in inspections completed in SESC year 2000, including those commenced in the previous SESC year.

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

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

- ① Bucket shop operations
- ② Conclusion of discretionary trade account contracts
- ③ Securities transactions conducted by securities companies for their own accounts at a better price prior to the execution of a customer's orders for the same stock
- ④ Representation of false or misleading statements on any material matter in connection with securities transactions
- ⑤ Solicitations with the promise of special profit to the customer
- ⑥ A series of transactions to create an artificial market without any reflection of the actual state of the market and the acceptance of orders for such transactions with the knowledge that it will form the artificial market
- ⑦ Additional payment to a customer's profits as a result of his/her securities transaction
- ⑧ Insufficient internal control on securities transactions from the standpoint of preventing unfair trading based on information on corporations that a securities company obtained
- ⑨ Selling underwritten securities to parent companies, etc.
- ⑩ Representation of an assured amount of dividends
- ⑪ Evasion of SESC's compliance inspections
- ⑫ Failure to deliver transaction reports
- ⑬ A mere shell of internal control
- ⑭ Securities transactions for speculative profit by the directors or employees of securities companies
- ⑮ Provision of property benefits to compensate for losses
- ⑯ Grossly inappropriate behavior of sales representatives concerning their duties

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

- ⑰ Receiving nonpublic information concerning customers from parent companies or providing such information to parent companies
- ⑱ Establishing offices or sharing electronic information in such a manner as to undermine its independence from its parent bank

● **Violation of self-regulatory rules**

- ⑲ Skewing the number of demanded securities in a demand research for IPOs
- ⑳ Securities transactions without the investor's consent by sales representatives
- ㉑ Margin transactions by sales representatives on the same account as the customer
- ㉒ Borrowing of the customer's name by sales representatives
- ㉓ Lending money to and borrowing money from customers by sales representatives
- ㉔ Advertisements by sales representatives without the permission of a compliance officer

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

- ① Solicitations of switching investments from dual currency bonds to other financial instruments, slighting the investor's interest
- ② Inappropriate sales practice in offering securities
- ③ Switching investment trusts on maturity without explaining the availability of preferential treatment for switching

(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

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laws and regulations

### **Section 5. Results of inspections of registered financial institutions**

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Inspections of registered financial institutions were conducted concerning their compliance with transaction rules, sales practices in soliciting investments, and internal control systems. As a result of those inspections, the SESC discovered that some financial institutions asked their customers to compensate for the losses caused by the operational failure of their institutions.

### **Section 6. Results of inspections of financial futures dealers**

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