

Chapter 3: Recommendations

Section 1. Outline

Based on the results of inspections and investigations of criminal offenses, the SESC may, if necessary, send recommendations to the prime minister and the commissioner of the FSA on disciplinary actions or other appropriate measures (hereinafter "administrative disciplinary actions") to ensure fairness in securities transactions (Article 20 (1) of the FSA Establishment Law (FSAEL)).

For example, the SESC is authorized to make recommendations on administrative disciplinary actions to be taken against securities companies that violate laws as well as recommendations requesting that SROs take necessary actions against securities companies that violate laws when the SROs have failed to do so even though the violation had been identified.

The SESC may request that the prime minister and the commissioner of the FSA report on actions taken based on the SESC's recommendations (Article 20 (2) of the FSAEL).

After receiving recommendations on administrative disciplinary actions based on the results of inspections made by the SESC, the prime minister and the commissioner of the FSA hold hearings with the parties involved and take administrative disciplinary actions, such as revoking the registration of securities companies or suspending their operations, when deemed necessary.

Because the JSDA is entrusted with administrative work related to the registration of sales representatives (Article 64-7 (1) of the SEL), the JSDA, based on SESC inspection results, holds further hearings with the parties concerned and takes such measures as revoking the registration of sales representatives or suspending their operations.

Section 2. Recommendations and actions taken

In the year under review, based upon the results of inspections and investigations, the SESC sent 34 recommendations to the prime minister and the commissioner of the FSA on administrative disciplinary actions against securities companies and directors or employees of securities companies.

The number of recommendations calling for administrative disciplinary actions against securities companies was 18. A total of 47 directors and employees were referred to in the SESC recommendations.

Violations of laws referred to in the recommendations are as follows:

1. Violations of laws by companies

- ① Bucket shop operations (violation of Articles 39 and 129 of the SEL)
 - On April 12, 1999, Daichu Securities Co., Ltd. (Daichu), which had purchased stocks of a listed company, executed customers' buy orders, with the involvement of a sales director, by taking the orders for its own account as a principal without making the purchases in the exchange securities market.

- ② Conclusion of discretionary trade account contracts (violation of Article 42 (1) (v) of the SEL)
 - From August 3, 1999, to August 3, 2000, an employee of the Tokyo Branch of Ark Securities Co., Ltd. (Ark), received orders from a customer and conducted stock transactions after concluding contracts that allowed Ark to determine whether to buy or sell, the selection of stocks, the number of stocks to be bought or sold, and the price without obtaining the customer's consent on each transaction.

From November 16, 1999, to July 10, 2000, an Ark sales manager received orders from a customer and conducted stock transactions after continuously concluding contracts that

allowed Ark to determine whether to buy or sell, the selection of stocks, the number of stocks to be bought or sold, and the price without obtaining the customer's consent for each transaction.

Although Ark identified discretionary trading committed by its employees several times in past inspections, it did not take any action to correct such activities. Under those circumstances, the SESC recognized the fact that the misconduct that was discovered in the latest inspection was caused by gross negligence of the internal control systems of Ark itself.

- From October 2000 to January 2001, a sales manager in the Asset Management Department of the Osaka Branch of KOKUSAI Securities Co., Ltd. (KOKUSAI), received orders from some customers and conducted stock transactions after concluding contracts that allowed him to determine the price of the transactions and/or the number of stocks to be bought or sold without obtaining the customer's consent for each transaction.

From July 1997 to December 2000, a director in the Asset Management Department of KOKUSAI received orders from some customers and conducted transactions after concluding contracts that allowed him to determine the price of transactions without obtaining the customers' consent for each transaction.

Although KOKUSAI identified discretionary trading committed by its employees several times in past inspections, it did not take any action to correct such activities. Under those circumstances, the SESC recognized the fact that the misconduct that was uncovered in the latest inspection was caused by gross negligence of the internal control systems of KOKUSAI itself.

- 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

- From January 2000 to February 2001, traders of Mizuho Securities Co., Ltd. (Mizuho),

executed orders from customers in addition to principal transactions. As a result, Mizuho often carried out transactions involving the same stocks as those in the customer's orders for its own account at better prices prior to the execution of customers' orders.

④ Representation of false or misleading statements on any material matter in connection with securities transactions (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL, including the application of Article 14 (1) of the LFSF)

- On April 12, 1999, Daichu, solicited orders from its customers to buy stocks at a price that was higher than the market price to switch its position of the stock to the customers without any losses by saying that there were sell orders at that price in the market. Actually, there were sell orders lower than that price, and the customers might have been able to buy the stocks at a lower price.
- Since February 23, 2000, H.I.S KYORITSU Securities Co., Ltd., showed false information on its website regarding customers' outstanding deposits, etc., to customers who transact their stocks through the website.
- On September 22, 1999, when selling a bond to several customers the Tokyo Branch of Rabo Securities Asia B.V. (Rabo) erroneously showed a unit price that did not include accrued interest. Although Rabo should have consulted with all those customers about revising the unit price, Rabo showed a false revised unit price of the bond only to major customers, hiding the fact that the revised unit price included the accrued interest for all customers. Rabo shifted the entire accrued interest only to customers with larger amounts of transactions without any explanation of the accrued interest.
- In May 2000, when NCS Securities Co., Ltd. (NCS), served an intermediary role in selling

commercial papers (CPs), it delivered, with the involvement of the representative director of NCS, etc., an explanation that mentioned that the CPs act as promissory notes (securities defined by the SEL). Although NCS came to know that the definition of CP does not correspond to that given by the SEL, it did not tell this to its customers.

July 2000, when NCS served an intermediary role in selling negotiable certificates of deposit (CDs) issued by a foreign corporation, it delivered, with the involvement of the representative director of NCS and others, an offer sheet to its customers. Although NCS came to know afterward that the name of the foreign corporation mentioned on the offer sheet changed due to a merger, NCS did not revise that information and delivered the same sheet repeatedly.

- From April 1996 to October 1997, Nikko Securities Co., Ltd. (Nikko), sold foreign bonds to many corporate customers. With the involvement of a director and other staff of the Bond Trading Division, Nikko misstated an explanatory note, which is a sales material, concerning the contents of foreign securities of the bonds and issued it to the customers. Those misstatements concerning a counter party of a currency swap and the preference of redemption.

- Nippon Global Securities Co., Ltd. (Global), sold exchangeable bonds *(EBs), the value of which was linked to the price of specific listed reference stocks, from May 1999 to May 2000. During its offering period, the price of reference stocks was already substantially below a predetermined strike price, and the economic benefit of purchasing the EBs rather than investing directly in the reference stocks was all but lost.

Nevertheless, Global failed to explain the disadvantages of investing in EBs to customers and, thus, made a misleading presentation.

Global sold other EBs, but some of the EBs were left unsold in both February and May

2000, even after its offering period. At that time, due to declines in the prices of reference stocks, the appropriate current prices of the EBs that were left dropped as well.

Under the circumstances, Global continued to sell the EBs to reduce its position of the EBs (even after the initially scheduled sales periods) at the same prices as the fixed initial sales prices, which were much higher than the appropriate current prices estimated from stock prices.

Hence, Global made misleading presentations in regard to the appropriate prices of EBs.

Note: EB is one of structured bonds that contains an obligation of seller of put options of reference stocks. EBs are sold for both retails and institutional customers in Japan. Normally, its maturity term is three or six month, and its interest rate is rather high compared to ordinary bonds due to a premium.

Unlike ordinary bond, its principal is not necessarily redeemed in full amount of cash. If the reference stock price (or index) at maturity date falls below a predetermined strike price, then the EB gets redeemed for the underlying securities with hidden losses.

- From January to August of 2000, with the involvement of the branch manager and a sales representative of its Oita Branch, KOKUSAI Securities Co., Ltd. (KOKUSAI), misstated sales materials of bonds. Although the principal of the bonds was not guaranteed, advertising postcards that were distributed to customers by the branch made false claims, as if the principal of the bond had been guaranteed.

- Shinko Securities Co., Ltd. (Shinko), sold an EB from May to July 2000.

During its offering period, the price of reference stock of the EB dropped substantially below the strike price, and the economic benefit of purchasing the EB rather than investing directly in the reference stock was all but lost.

Nevertheless, Shinko failed to explain the disadvantages of investing in the EB and, thus, made a misleading presentation.

Shinko sold other EBs, but some of the EBs were left unsold in both July 2000 and June 2001. At that time, due to declines in the prices of reference stock of the EBs, the appropriate current prices of the EBs that were left dropped as well.

Under the circumstances, to reduce its position of the EBs without losses, Shinko continued to sell the EBs (even after its offering periods) at the same prices as the fixed initial sales prices, which were much higher than the appropriate current prices estimated from stock prices.

Hence, Shinko made misleading presentations in regard to the appropriate prices of EBs.

- ⑤ Solicitations with the promise of special profits to the customer (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL, including the application of Article 14 (1) of the LFSF)
 - On June 26, 1998, Daichu, with the involvement of the branch manager of its Umeda Branch, solicited the purchase of securities based on promises that the company would switch trading, which is at a lower price than the current market price, to the customer's account.
 - The Tokyo Branch of West LB Securities Pacific Limited (West LB) was asked by several corporate customers (insurance companies) to arrange for financial institutions to supply subordinated loans to them in order to improve their solvency margin ratio. However, West LB could not find appropriate financial institutions to supply the loans. In March 1998 and 1999, with the involvement of the branch manager, a director of financial products division, and others, West LB offered its corporate customers a scheme that made the credit risks of subordinated loans return to the customers themselves. The scheme was for the customers to buy a structured bond, the amount of principal payment of which links with the credit risks

of the subordinated loans. On the other hand, they obtained subordinated loans from financial institutions. In this scheme, obtaining subordinated loans was not to strengthen the claims-paying ability of the customers but to pad their solvency margin ratio in appearance.

- In November 1997, CIBC World Markets (Japan) Inc. (CIBC) proposed to a corporate customer a scheme to defer a loss of a note, which was nearly of no value at the time, by adding a new fund. In this scheme, a pecuniary profit was also promised to the customer. Consequently, the whole process was purported to avoid the realization of a loss from the original note.

In October 1998, CIBC promised a corporate customer that, when it made an advance payment for a new note to a checking account in a CIBC-affiliated bank, CIBC would add interest to the new note corresponding to the duration of the deposit, in fact that the checking account itself does not normally produce any interests.

- In June 1998, Tokyo-Mitsubishi Securities Co., Ltd. (Tokyo-Mitsubishi), bought bonds from a corporate customer and then sold them to its parent company by customer order. Thereafter, customers requested that Tokyo-Mitsubishi annul the bonds transactions, nevertheless.

In July 1998, Tokyo-Mitsubishi, in an agreement with its customers, carried out additional transactions that could cancel out the effects of the original transactions. Under the newly proposed transactions, Tokyo-Mitsubishi bought back the bonds from the original buyer and sold them back to the customer concerned.

Because the second buy-back and sell-back were at the same price as the original transactions, the brokerage commission, which Tokyo-Mitsubishi gained from the original transactions, was provided to the customers. Moreover, Tokyo-Mitsubishi promised to exempt the brokerage commission from those reverse transactions. This can be identified as

an act of solicitation for securities transactions with a promise to provide special profits.

- In November 1998, the Osaka Branch of KOKUSAI was requested by a corporate customer to make a donation of an amount that was extraordinary for KOKUSAI.

In response to the request, with the involvement of the branch manager, and the director and sales manager of the Asset Management Department, KOKUSAI offered the corporate customer two issues of IPO stocks in place of the donation in December 1998. As these two IPO issues were expected to rise in price, despite the fact that only a few units of the IPO stocks were available in the Osaka Branch, KOKUSAI intended to distribute to the corporate customer the IPO stocks arbitrarily, with a view to providing special profit.

With offering the above special profit, KOKUSAI solicited an asset manager of the corporate customer to purchase IPO stocks.

- From January to June 1998, with the involvement of a vice manager of its Tokyo Branch, Societe Generale Securities (North Pacific) Ltd. (Societe Generale) solicited several corporate customers with promises to avoid realizing a redemption loss of a note that the customers purchased before by a scheme in which the conditions of the note would be altered mainly in order to defer its redemption loss. In fact the value of the note just before redemption was almost nothing.

From March 1995 to June 1998, with the involvement of the general manager of its Tokyo Branch, Societe Generale solicited a customer (a securities investment advisor) with a promise to provide rebate towards orders from the customer under the pretext of an advisory fee.

- 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 (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL)

- From April 9, 1999, to August 18, 2000, Murosei Securities Co., Ltd. (Murosei), with the involvement of a division director, accepted and executed a series of buy orders for listed stocks from a customer knowing that the customer was trying to raise the prices of the stocks by consecutively placing buy market orders or buy limit orders at higher prices than the latest prices in order to reduce unrealized losses on them.

Murosei neglected proper management and supervision in accepting and executing a series of orders from a customer.

- In relation to an EB for stocks of a listed company, for the purpose of lowering the stock price, Tokyo-Mitsubishi, with the involvement of two directors in its Equity Division, sold the reference stocks by placing a series of lower-limit or market buy orders from 14:59 until the close on January 17, 2001. In fact, whether additional interests (bonus coupon) of the EB were payable was dependent upon the stock price on January 17, 2001.

As a consequence of the deliberate selling, the stock price fell short of the benchmark price for additional interests, and a payment worth approximately ¥365 million was not made.

⑦ Additional payment to a customer's profits as a result of his/her securities transaction (violation of Article 42-2 (1) (iii) of the SEL, including the application of Article 14 (1) of the LFSF)

- On September 22, 1999, the Tokyo Branch of Rabo offered its unit price, which was substantially lower than the proper price, only to some particular customers. Consequently, to make them acquire property gains, Rabo provided approximately ¥8,500,000 in total to them.

- From October 1 to 6, 1999, with the involvement of a section chief in its Nishinomiya

Branch, Nikko provided property gains to a customer for the purpose of increasing the customer's gains by distributing IPO stocks intentionally. In fact, those stocks were expected to rise, and the branch had only a few units of the stocks to be distributed.

⑧ Insufficient internal control on securities transactions from the standpoint of preventing unfair trading based on information on corporations that a securities company obtained (violation of a Ministerial Ordinance, Article 43 (2) of the SEL)

- On August 11, 1999, Mita Securities Co., Ltd. (Mita), concluded a basic contract with a corporate customer regarding the transaction of equity stocks for the retirement of shares. Mita had received nonpublic information concerning customers' decision to buy equity stocks by accepting buy orders from customers between August 12, 1999, and May 17, 2000.

Mita disregarded the internal rule and did not take any action, such as banning proprietary trading, despite the fact that it received information on its corporate customer. Moreover, the person who was in charge of proprietary trading concurrently held the post of agent trading.

In these circumstances, a sales manager who was responsible for proprietary trading traded the stocks on his own account, knowing that the customer was giving a buy order for the same stocks to retire shares on March 27, 2000.

⑨ Selling underwritten securities to parent companies, etc. (violation of a Ministerial Ordinance, Article 45 (3) of the SEL)

- From August 1999 to November 2000, Mizuho sold underwritten stocks to its parent companies and others within six months of the date of the underwriting of those stocks.

⑩ Representation of an assured amount of dividends (violation of Article 171 of the SEL)

- From July 1999 to April 2000, when selling several stocks to customers, Toyo Securities Co., Ltd., with the involvement of the director of its Nagoya Branch, stated in its presentation

that the shareholders of those stocks could get a certain amount of annual dividends.

⑪ Evasion of SESC's compliance inspections (violation of Article 198 (5) (viii) of the SEL)

- In relation to the acts of concluding agreements on discretionary transactions by brokers, KOKUSAI, with the involvement of its general manager and the director and the sales manager of its Osaka Branch, requested customers to answer falsely to inspectors, indicating that such illegal agreements were never concluded.

Moreover, KOKUSAI, with the involvement of its general manager and the director of its Osaka Branch, gave a false answer to a question asked by inspectors concerning who in the branch took care of a specific customer. Although the director of the branch was in charge of the customer, KOKUSAI deliberately hid that fact and said the name of another branch employee.

In relation to the solicitation of transactions with promises to provide a special profit, KOKUSAI, with the involvement of an executive officer and general manager of its Head Office and the sales manager of its Osaka Branch, gave false answers, which deliberately hid the facts regarding questions asked by inspectors concerning the distribution of IPO stocks.

⑫ Failure to deliver transaction reports (violation of Article 205 (2) (iv) of the SEL)

- Although transaction orders accepted from many customers on February 21, 2000, through the Internet was concluded the next day, H.I.S. Kyoritsu did not deliver the statements of transaction to the customers.

⑬ A mere shell of internal control

- The president and representative director of NCS did not give appropriate instructions on complying with market regulations to the other directors and employees despite the

president's responsibility of taking the lead in strengthening the function of internal control. The fact that the president pushed forward transactions, ignoring the advice of the person in charge of internal control and others to cancel the transactions, shows the president's remarkable lack of awareness of compliance.

Although the person in charge of internal control and others advised the president to cancel the transactions, they finally obeyed the president's order. In that sense, the internal check system did not work appropriately.

2. Violations of laws by directors and employees

In the year under review, the SESC made recommendations against directors and employees (those registered as sales representatives) of securities companies concerning the following violations of laws:

① Conclusion of discretionary trade account contracts (violation of Article 42 (1) (v) of the SEL)

Sales representatives concluded contracts that gave themselves discretionary power to make decisions concerning all or some items in stock and other transactions, namely, whether to buy or sell, the selection of stocks, the number of stocks to be bought or sold, and the price, without consent from customers on each transaction, and they actually received orders and conducted transactions. (Recommendations made against 12 companies and 21 individuals)

② Representation of false or misleading statements on any material matter in connection with securities transactions (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL)

A sales representative erroneously executed more orders in stock transactions than he accepted from a customer and gave the customer false details of the transactions. Although he knew that he gave false information to his customer, he did not correct his mistake. (Recommendations made against one company and one individual)

Sales representatives presented false information by delivering misstated sales materials of foreign securities. Although the principal of the securities was not guaranteed, the materials that were distributed to customers by the sales representative made false claims, as if the principal of the stocks had been guaranteed. (Recommendations made against two companies and two individuals)

- ③ 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 (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL)

Sales representatives intentionally lowered the price of listed stocks by making use of sell orders from customers or placing sell market orders or sell limit orders lower than the latest prices on their own accounts. (Recommendations made against three companies and five individuals)

A sales representative accepted and executed a series of buy orders for listed stocks from a customer knowing that the customer was trying to raise the prices of the stocks by consecutively placing buy market orders or buy limit orders at higher prices than the latest prices. (Recommendations made against one company and one individual)

- ④ Securities transactions for speculative profit by directors or employees (violation of a Ministerial Ordinance, Article 42 (1) (ix) of the SEL)

In order to increase sales performance and pursue their own profits, sales representatives conducted trading in stocks on their own judgment on many occasions by using customers' accounts. (Recommendations made against five companies and six individuals).

- ⑤ Provision of property benefits to compensate for losses (violation of Article 42 (2) (i) 3 of the SEL)

A sales representative transferred money into a customer's account in order to partially compensate for losses on stock trading and, thus, providing property benefits.
(Recommendations made against one company and one individual)

- ⑥ Grossly inappropriate behavior of sales representatives concerning their duties (violation of Article 64-5 1 (2) of the SEL)

Sales representatives concluded contracts that gave themselves discretionary power to make decisions concerning some items in mutual fund transactions, namely, whether to acquire or cancel, the selection of stocks, and the number of stocks, without consent from customers on each transaction, and they actually received orders and conducted transactions.
(Recommendations made against three companies and four individuals)

Sales representatives received orders from customers and conducted transactions knowing that the customers used other people's names. (Recommendations made against three companies and three individuals)

A sales representative purchased stocks without the consent of the customer.
(Recommendations made against one company and one individual)