

Chapter 4: Proposals

Section 1. Outline

Based on the results of inspections and investigations of criminal offenses, the SESC may, if necessary, give proposals to the prime minister, the commissioner of the FSA, and the Minister of Finance to ensure fairness in securities transactions (Article 21 of the FSAEL).

Proposals are designed to present the SESC's comprehensive analyses of incidents uncovered in 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 given by the SESC are important materials to be used in making judgments when administrative departments prepare their policies.

Section 2. Proposals

During the year under review, the SESC did not find the case, which needs the proposal to the Prime Minister, the Commissioner of the FSA, and the Minister of Finance on the basis of the results of inspections and investigations of criminal offenses.

Chapter 5: Market Surveillance

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 fairness in securities transactions and the protection of investors. These activities are carried out under the authority delegated by the prime minister and the commissioner of the FSA, as prescribed in the SEL, LFSF, and FFTL. The SESC conducts the 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 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 FFAs

The SESC also maintains close relationships with the market surveillance sections of SROs, including stock exchanges and the JSDA, by sharing necessary information on a regular basis or upon request or by making references to factual information.

Section 2. Market surveillance

1. Market surveillance

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

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

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

(1) Related to market manipulation	62 cases
• Sharp stock price rises	51 cases
• Pegged stock price movements	3 cases
(2) Related to insider trading	190 cases
• Downward revision of earnings estimate	36 cases
• New share issues	30 cases
• Upward revision of earnings estimate	21 cases
(3) Others, including the spreading of rumors	13 cases

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

Conducted by the SESC	144 cases
Conducted by regional offices	121 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 was centered on sudden stock price rises and other unnatural movements. Stocks that were under surveillance due to 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

prices to rise, such as the announcement of revisions to earnings estimates and new stock issues. Cases concerning the suspicion of insider trading involved the directors and employees of companies that have business relationships with issuers in addition to the directors and employees of the issuers.

Surveillance concerning the spreading of rumors centered on stocks with prices that fluctuated significantly due to various types of information as well as EBs and bonds linked to the Nikkei average.

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.

Chapter 6: Other Activities

Section 1. Publishing the Inspection Manual for Securities Companies

In the year under review, the SESC published the Inspection Manual for Securities Companies in collaboration with the FSA to improve inspections and ensure the transparency of financial administration.

On August 2000, the SESC, in collaboration with the Inspection Division of the FSA, created a taskforce and began making the manual. The taskforce finalized the manual on June 14, 2001, through the public comment process, which was to be applied to inspections commencing after October 1, 2001. In addition to the publication of the manual, the SESC announced on the same day that it began accepting the opinions of securities companies under inspection.

Section 2. Dealing with new financial devices

With the globalization of the market and the lingering low interest rate in recent years, new financial devices made by the application of advanced derivative techniques began to be sold to public investors. As investor's needs diversify, various financial devices are offered to investors that, on the one hand, are expected to enhance market effectiveness and, on the other, include potential risks.

In the year under review, the SESC requested reports from securities companies that deal with EBs. The SESC sent five recommendations concerning law violations that were uncovered in SESC inspections to the prime minister and the commissioner of the FSA on disciplinary actions or other appropriate measures.

The SESC has gathered information through inspections and daily market surveillance in order to ensure fair transactions. Especially in the year under review, the SESC tried to gather various information regarding not only EBs but also bonds linked to the Nikkei average and other new financial devices, which influences markets and investor protection, as well as solicitation activities.

Section 3. Dealing with 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.

In addition, the increase in Internet use for securities transactions, which was prompted partly by the liberalization of brokerage commissions, increased the importance of market surveillance of unfair trading over the Internet.

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

2. Inspections of on- line brokers

The SESC inspects securities companies that carry out transactions over the Internet, focusing on such internal controls of the companies as trading and transaction management.

On December 2000, the SESC uncovered violations of the SEL (nondelivery of transactions reports and the giving of false or misleading information related to securities and other trading) and sent a recommendation on administrative disciplinary actions.

3. Internet surf day

The Internet causes dramatic changes in securities markets and makes it easier for investors to obtain more information. On the other hand, the Internet creates new methods of conducting illegal activities in securities markets. Because the Internet can transmit information around 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, 41 securities and futures regulators among the members of the IOSCO coordinated their efforts on April 23, 2001, following March 1999, in order to simultaneously identify illegal securities and futures activities on the Internet.

Approximately 27,000 sites on the Internet were surveyed, and the regulators agreed to follow up on about 2,400 sites. The SESC surveyed 1,888 sites on the Internet and reported to the IOSCO that it would follow up on 21 sites, including sites involving cross-border activities.

4. IPS (Internet Patrol System)

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

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

The system conducts the automatic and regular patrol of specified websites to collect and accumulate information and permits the retrieval of information on specified issues as the 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 4. Seeking/Receiving information from the general public

Information provided by telephone, personal visits, fax or mail, or over the Internet through feedback from the general public is useful in inspections, market surveillance activities, and investigations of criminal offenses. The SESC established a system for receiving such information and has been actively seeking information from the general public.

In the year under review, the number of pieces of information the SESC received hit a record high of 1,356, up approximately 70% from the previous year. The breakdown of the information are as

follows: 606 from Internet feedback, 390 over the telephone, 64 from visits, 205 by mail, and 91 forwarded from the FSA and regional offices. By type of information, 671 pieces were related to specific stocks, 356 were related to the sales practices of securities companies, and 329 were opinions directed to the SESC.

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

Among the information concerning the sales practices of securities companies, cases of discretionary trading account transaction contracts were the most frequently seen. This was followed by cases of transactions without the customer's consent (see Table 2).

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

Table 2 : Information Received (last Three years)

Methods

	SESC Year 1998	SESC Year 1999	SESC Year 2000
Internet	49	359	606
Telephone	77	198	390
Mail	55	156	205
Visits	21	19	64
Forwarded from the FSA and regional offices	39	57	91
Total	241	789	1,356

Contents

	SESC Year 1998	SESC Year 1999	SESC Year 2000
Specific stocks	147	385	671
Suspected market manipulation	51	162	317
Suspected insider trading	32	90	122
Suspected submission of false securities reports	11	39	85
Suspected profit guarantee and loss compensation	10	15	8
Others (spreading of rumors, etc.)	43	79	139
Sales practices of securities companies	66	200	356
Transactions without customers' consent	15	16	35
Solicitations with definitive predictions	5	7	35
Solicitations taking advantage of customer's lack of knowledge	3	21	17
Conducting discretionary transactions	7	6	49
Large-volume recommendation sale	2	3	5
Others	34	147	215
Others, including opinions, etc., directed to the SESC	28	204	329
Total	241	789	1,356

Note: The SESC year is from July 1 to June 30 of the following year.

Section 5. Cooperating with foreign regulatory authorities

Along with the internationalization of securities transactions, there has been cross-border misconduct affecting fairness in markets around the world. As a result, international cooperation in the field of law enforcement has become increasingly important in ensuring fairness in domestic markets.

Taking this situation into consideration, the SESC continued to actively promote international cooperation in the year under review by, for example, 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 of other countries. The SESC promotes the sharing of information on vital issues with foreign regulators at the annual IOSCO meeting and through individual interviews at various levels.

Note: The IOSCO is an international forum that promotes international harmonization in securities regulations and cooperation among securities regulators. As of December 2000, 162 institutions from 96 countries, provinces, and regions around the world are members of the IOSCO.

2. MOUs

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

Section 6. Strengthening surveillance systems

Since 1993, the SESC has been developing its Securities Comprehensive Analyzing System (SCAN-System), which can be broadly utilized in 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 the outline of inspection results for the analyses of the 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, to conduct the surveillance of insider trading, market manipulation, and other activities as well as to make a quick and comprehensive reference to listed or over-the-counter stocks showing unnatural price movements and the content of announcements of important facts and transactions. This system has been in operation since 1997. IOSCO

The SESC has continued to develop the SCAN-System in order to further improve their functions. In the year under review, the SESC developed surveillance by technical analysis of corporation finance (STAF) to more efficiently analyze false financial reports submitted by stock issuing companies. The SESC also strengthened the function of the IPS to the complete surveillance of various pieces of information on the Internet.