

2. Inspections

1) Outline

1. Inspections to ensure fair trading

(1) **Objectives and scope of SESC inspections**

The SESC conducts on-site inspections of securities companies and other entities to supervise their compliance with laws and regulations and ensure fairness in securities transactions. The inspections are conducted under the authority delegated to the SESC by the Prime Minister and the FSA Commissioner, as prescribed under the SEL, LFSF and FFTL.

(2) **Scope of Inspections**

The scope of inspections is prescribed under government ordinances (Article 38 of the SEL Enforcement Order, Article 20 of the LFSF Enforcement Order and Article 9 of the FFTL Enforcement Order). Acts by securities companies, their executives or their other employees that are prohibited (securities trading meant to create an artificial market that does not reflect the actual state of the market, false statements about securities trading, misleading statements about important investment factors and the act of soliciting business with promise to provide special benefits) and suspected violations of securities laws and regulations, including guarantee of repayment of investment losses, reimbursement of investment losses, price manipulation and insider trading, are subject to inspection.

2. Inspections to verify traders' identity

(1) **Objectives and scope of SESC inspections**

The SESC conducts on-site inspections of securities companies and related entities to check if these companies are taking adequate measures to verify their customers' identity and maintain their transaction records.

The inspections are mainly aimed to encourage securities companies to upgrade their customer management system.

(2) **Scope of inspections**

Based on the authority to inspect securities companies and collect their investment reports and data, which is prescribed under the Personal Identity Verification Law (PIVL), the SESC conducts inspections of securities companies to check if they have verified the identity of customers (Article 3 of the PIVL) when there is suspicion that the customer is receiving securities brokerage services from the securities companies by pretending to be the person whose name is registered for the transaction or that the customer is falsifying his or her name, address and date of birth (in the case of a corporate entity, the corporate name and location of the head office and main offices). Under such circumstances, the SESC also conducts inspections of the securities companies to check if they have prepared documents after the verification and have kept these documents (Article 4 of the PIVL).

2) Basic inspection policy

Clerical work and other management for inspections are run on a one-year cycle. Each SESC year begins on July 1 and ends on June 30 of the following year.

At the beginning of each SESC year, the SESC devises a basic inspection policy and plan to ensure that inspections conducted by the SESC and local Finance Bureau chiefs are managed and implemented smoothly and efficiently.

The basic policy determines priority items and other basic matters for inspections for the new year, while the basic plan specifies the number and types of securities companies which will become subject to inspections for the year from among domestic brokerage houses, foreign securities houses and other financial institutions registered for securities trading.

3) Results of inspections

1. Outline of inspections

In the 2002 SESC year, the SESC launched inspections of 95 securities companies, 18 foreign securities houses and 13 other financial institutions registered for securities trading. In line with the enforcement of the PIVL in January 2003, the SESC conducted inspections of all securities companies which offer online brokerage services. The inspections in the 2002 SESC year were mainly on focused areas or topics reflecting new moves and developments in the securities industry. Among inspections under such circumstances were those utilizing the results of analysis made by the Market Surveillance Office and those focusing on securities houses whose primary business is trading on their own account.

2. Outline of securities company inspection results

The SESC completed inspections of 135 companies in the 2002 SESC year, including those whose inspections were carried over from the previous year. Of the 135 firms, problems were found at 78 companies. (The 78 firms accounted for 58% of the total.) Violations of market rules and others were detected at 50 companies. Other problems found in the inspections concerned how business was solicited from customers and in-house management of business operations. Some securities companies were found to have the same problems as were detected in the previous inspections.

(Reference: Problems were found at 63% of the inspected firms in the 2001 SESC year, 63.9% in the 2000 SESC year and 85.1% in the 1999 SESC year)

Following are the main points of what were found in the inspections in the 2002 SESC year.

- (1) **Act of making a series of securities transactions meant to create an artificial market that does not reflect the actual state of the market**

In so-called closing-price trading, some securities companies' divisions in charge of own-account trading engaged in series of transactions meant to create an artificial market with the aim of raising the closing price of the reference stock. The transactions were made at a time when the profit of the securities companies was to become larger if the closing price of the reference stock rose. Some other securities companies also engaged in illegal transactions in exchangeable bond (EB) trading, in which large quantities of limit sell orders were placed for the reference stock with the intention of making the price of the reference stock lower than the EB's strike price so that the EB would be redeemed in the form of delivery of the shares.

In addition, stock traders in charge of the companies' own accounts were found to have repeatedly placed buy or sell orders for certain stocks despite having no intention to execute them. The act was intended to induce orders by other market players by making the initial orders look stronger than actual demand.

(2) Business solicitation methods which should be rectified from a viewpoint of protecting individual investors

In underwriting of corporate bonds by securities companies, individual investors were placed in a disadvantageous position as pricing was determined without their knowledge of important market-moving factors despite significant changes in the bond market, including a sharp increase in undergoing yields. In new corporate bond sales to individual investors, some securities companies solicited business without informing the investors of the fact that yields on the bond surged in the secondary market after the bond issuer's credit rating was lowered just before the start of the new bond sale.

(3) Inadequate in-house systems at online brokerage houses to check dubious transactions

Securities houses specializing in Internet trading have yet to establish systems to check shady transactions, including orders apparently placed to dodge regulations on short selling. Some other online securities houses did not take action to thoroughly check illicit deals even though their in-house system detected problems in which an artificial market appeared to have been created for certain stocks after the placement of Internet orders for the stocks.

(4) Repeated violations by the same securities companies

Despite their having been given warnings repeatedly in past inspections, the same securities companies were also found to have violated law in the 2002 SESC year by concluding contracts with customers for discretionary-account trading.

(5) Failure to verify traders' identity

Some securities companies did not take measures to verify the customers' identity even though they had suspicions that the customers were receiving stock brokerage service from the securities companies by pretending to be the persons whose names were registered for the trading.

3. Inspections of self-regulatory organizations

In May 2001, the SESC and the Inspection Bureau of the FSA jointly launched inspections of trading at the Tokyo Stock Exchange (TSE) and the Osaka Securities Exchange (OSE). The SESC issued a report on the results of the TSE inspections and informed the TSE of the results on March 27, 2003.

The inspections of the TSE and the OSE were launched to make a comprehensive examination of the operations and the finances of the two bourses in response to the exchanges' organizational shift to stock companies and an increasing need to raise the role of self-regulatory organizations in the securities industry.