

3. Inspections towards regulated market intermediaries

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 market intermediaries entities to check their compliance with laws and regulations for ensuring fairness in securities and financial futures 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 cabinet orders (Article 38 of the SEL Enforcement Order, Article 20 of the LFSF Enforcement Order and Article 9 of the FFTL Enforcement Order). Specifically, securities companies are inspected in connection with provisions concerning prohibited acts of securities companies and those of their executives or employees. Such prohibited acts include a series of securities transactions carried out with intent to create an artificial market that does not reflect the actual market, representation of false statement concerning securities trading or misleading statement with respect to material matter concerning securities trading, and solicitation of securities trading with special profit guarantee.

2. Inspections with respect to confirming customers' identity

(1) Objectives and scope of SESC inspections

Under the authority entrusted by the Prime Minister and the FSA Commissioner based on the Law on Customer Identification and Retention of Records by Financial Institutions and prevention of unlawful use of Deposit (LCIRR), the SESC conducts on-site inspections of securities companies and related market intermediaries entities to check if these companies are taking adequate measures to confirm their customers' identity and maintain their transaction records.

The inspections are mainly aimed to encourage securities companies to improve their customer control system.

(2) Scope of inspections

Based on the authority to inspect securities companies and order to produce documents, which is prescribed under the LCIRR, the SESC conducts inspections of securities companies to check if they have confirmed the identity of a customer (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 other 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 and Basic Inspection Plan

Inspections are planned and executed 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 establishes a basic inspection policy and

a basic inspection plan of the year 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 year, while the basic plan specifies the number and types of companies which will become subject to inspections for the year among domestic brokerage houses, foreign securities companies and other financial institutions registered for securities business.

3) Results of inspections

1. Outline of conducted inspections

During the 2004 SESC year, inspections were initiated of 96 domestic securities companies, 17 foreign securities companies and 27 financial institutions registered for securities business.

2. Outline of securities company inspection results

During the 2004 SESC year, inspections of 118 securities companies were completed. Problems were found in 55 of these companies, representing 47% of all the companies inspected. In 45 of these companies, violations of market rules, etc. were found. In addition, a number of problems concerning the way these companies have conducted business and those relating to their internal control systems were identified. In particular, some securities companies were found to have concluded into discretionary account trading contract in the 2004 SESC year in spite of the fact that this violation had been pointed out multiple times in previous inspections. The SESC therefore made recommendations of taking administrative disciplinary measures against these companies to the Prime Minister and the Commissioner of the FSA.

(Note: Problems were found among 52% of the companies inspected in the 2003 SESC year, 58% in the 2002 SESC year and 63% in the 2001 SESC year.)

3. Outline of registered financial institution inspection results

During the 2004 SESC year, inspections of 28 financial institutions registered for securities operations were completed. Inspections of registered financial institutions were conducted in essentially the same areas as those for securities companies, namely, compliance with market rules, the ways of their business such as solicitation of investment, and internal control systems. The inspections revealed the following problems with some of the registered financial institutions:

- (i) Representation of misleading statement with respect to material matters in the course of handling private placement of securities.
- (ii) Handling private placement on a condition of granting credit.
- (iii) Failures to confirm the identity of customers in transactions in which there was a possibility that the customers assumed the identity of others [in violation of Section 1, Article 3 of the LCIRR].

4. Inspections of Financial Futures Traders

Inspections of financial futures traders were carried out concurrently with the inspections of securities companies. Their compliance with market rules was checked and inspectors identified the ways that they solicit customers to invest in financial futures. The inspections found no particular problems.

5. Inspections of Self-Regulatory Organizations

Generally, the SESC together with the Inspection Bureau of the FSA conducts their inspections of Self-regulatory organizations simultaneously, aiming to comprehensively examine the business operations and financial management of the securities exchanges, recognizing the trend among the securities exchanges to become stock companies and the growing importance of the Self-regulatory operations.

In May 2004, the SESC conducted an inspection of the Nagoya Stock Exchange and completed the inspection in July 2004 by issuing the notice of inspection results.