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Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2020–June 2021)

Introduction

The missions of the Securities and Exchange Surveillance Commission (SESC) are: (1) ensuring market integrity and transparency/protection of investors, (2) contributing to the sound development of markets, and (3) contributing to sustainable economic growth.

Under these missions, the purpose of the SESC's monitoring of financial instruments business operators (FIBOs, or securities businesses¹) is to ensure investors' confidence in the markets. For this purpose, the SESC encourages FIBOs² to enhance self-discipline in performing their function as market intermediaries and to operate properly in compliance with relevant laws, regulations, and market rules. It also seeks to examine the actual situations of securities businesses swiftly and in depth.

In "*Strategy & Policy of the SESC 2020-2022*," released in January 2020, the SESC cited "risk-based examination of financial instruments business operators" as one of the concrete measures to fulfill its mission for the period. For this measure, the SESC has been collaborating with relevant departments of the Financial Services Agency (JFSA), based on "*Assessments and Strategic Priorities*,"³ etc.

Under such circumstances, the SESC formulated and published⁴ in June of this year its "Basic Principle Of Security Business Monitoring" (hereinafter, "Basic Principle") to clarify and share points to focus on and matters to note in inspection/supervision for further promoting seamless on-site and off-site securities business monitoring, and announced that it would be conducting securities business

¹ "Monitoring of securities businesses" in this document includes both on-site and off-site monitoring. On-site monitoring means inspections conducted at the site, while off-site monitoring means a wide range of monitoring activities carried out by the SESC, Local Finance Bureaus and others, other than on-site inspections, which may include interviews with and reports from FIBOs and information collection through exchanges of opinions with relevant parties.

² FIBOs or securities businesses are any businesses that are subject to securities monitoring pursuant to the Financial Instruments and Exchange Act, including financial instruments business operators, registered financial institutions, financial instruments intermediaries, persons who have notified that they are engaging in business specially permitted for qualified institutional investors, credit rating agencies, and other entities.

³ Combines "Strategic Directions and Priorities" and "Progress and Assessment of the Strategic Directions and Priorities," and has been published since business year 2018.

⁴ The "Inspection Manual for Financial Instruments Business Operators" (otherwise known as the "Securities Inspection Manual") was discontinued as part of this approach.

monitoring pursuant not only to the SESC's own policies but also the Comprehensive Guidelines for Supervision published by the FSA and the ideas and approaches presented in discussion papers, etc., for each principle and sector.

This document outlines the basic monitoring policy for FIBOs and sets forth the areas of focus in the monitoring activities in the 2020–2021 business year.

1. Monitoring Priorities for Securities Businesses

(1) General environment surrounding securities businesses

The global economy continued its gentle recovery until the beginning of this year but, although domestic stock prices rose in the second half of last year, trading volume declined and interest rates remained at historically low levels. Under these circumstances, competition over commission fees has intensified among FIBOs, making it difficult to secure earnings under conventional business models reliant on commission income.

With digitalization making steady headway, the securities industry has seen HFT volume climb, legal reforms passed to bring cryptoasset derivatives under regulation, and regulations put in place to govern security tokens, raising the importance to establish internal control environments for them.

In addition, robust cybersecurity against cyberattacks remains vital as next year's Tokyo Olympic and Paralympic Games approach.

Efforts must also be made to adopt more sophisticated Anti-Money Laundering/Counter the Financing of Terrorism (hereinafter, "AML/CFT") approaches in line with FATF's fourth mutual evaluation of Japan.

At the same time, the worldwide coronavirus pandemic has destabilized financial and capital markets in Japan and elsewhere, and due attention must be paid to the impact of the coronavirus pandemic on economies and markets.

(2) Approach to monitoring securities businesses

Securities businesses subject to monitoring by the SESC currently total approximately 7,500. These firms offer an increasingly diverse, complex set of services and products, and include businesses that have yet to introduce adequate basic control environments for compliance and investor protection.

Regulatory authorities must therefore make their best efforts to conduct effective, efficient monitoring of securities businesses as well as to promptly

identify risks that could undermine investors' confidence based on the risk characteristics of FIBOs, and to do so with limited human and other resources in view of "basic principles".

The SESC will continue working with the relevant bureaus of the JFSA in making risk assessments of all FIBOs and other companies to be monitored from a multifaceted perspective extending beyond business categories and scale to include business models and other factors, and conducting seamless on-site/off-site monitoring whereby companies are selected for on-site monitoring on a risk basis.

In conducting on-site monitoring, the SESC aims not only to point out problems and to take actions such as making recommendations for administrative disciplinary actions, but also to analyze the whole picture of the problems to identify their root causes, so that businesses can address them and prevent recurrence.

Furthermore, if the need to improve business operations or other potential issues is identified before any problems materialize, the SESC will share the findings with the monitored businesses and urge them to build effective internal control environments or take other actions to address the issues.

(3) Activities in the last business year

In the last business year, with respect to security firms, the SESC thoroughly conducted on-site monitoring after gathering information on business model trends and the circumstances surrounding overseas outsourcing of back office operations, and understanding each company's risks. As a result, some securities firms were found to have compensated certain customers for losses or committed other malicious violations of laws and regulations, and multiple cases have been uncovered of problematic sales approaches and customer service that include making solicitations that disregard the investment intentions of elderly customers, undertaking trades at the initiative of sales personnel primarily to generate commission fees, and not accepting termination of investment trusts. The SESC also examined AML/CFT measures in a prioritized fashion in view of growing international interest.

With respect to investment management business operator, the SESC conducted on-site monitoring on business operators belonging to corporate groups or primarily outsourcing investment management as well as private placement business of real estate investment trust(REIT) from the perspective

of control measures, including those to prevent conflicts of interest. As a result of the on-site monitoring, the SESC found the case where a business operator had failed to perform investment management business faithfully on behalf of beneficiary owners of investment trusts. In this case, a business operator included the custodian fee increase as one of the termination conditions, in the negotiation with outsourcing contractors over the company's own termination fee and accepted the custodian fee increase without examining its rationale. This imposed burdens on the assets of customers having no liability whatsoever under the outsourcing agreements.

With respect to Type II FIBOs and investment advisors/agencies, the SESC identified high risk businesses from among the large number of businesses falling under these categories and carried out on-site monitoring based on the analyses of risks associated with their products and information provided by outside sources. As a result, multiple cases of impropriety were uncovered at investment advisory and agency business operators, including a case of name-lending to a third party, a case in which an investment advisory company posted false investment advisory performance and posted articles designed to look as though they were posted by third party on a website, and another case in which a customer's trading was used and illegitimate advice provided to benefit a third party other than the customer.

The SESC also conducted on-site monitoring on credit rating agencies.

Furthermore, the SESC sought court injunctions to force the cessation and suspension of activities at, among others, unregistered Type II FIBOs that caused a large amount of damage to general investors.

(4) Policy for activities in the current business year

As it is becoming increasingly difficult for the traditional business model dependent on sales commission income to secure earnings, many FIBOs are seeking to transform to a stable-earning structure by increasing assets under management as a sales method in recent years. They have also begun expanding their product lineups to include overseas financial products and higher-return funds.

Due attention must also be paid to the impact of the coronavirus pandemic on the management environment and business operations of FIBOs.

In the current business year, the SESC will assess risks focusing on the situation such as the above, and continue to proactively conduct on-site

monitoring for in-depth examinations where it is necessary to comprehend further details in the event that:

- ① a relevant law and/or regulation is breached or there is a deficiency in business operations that requires a prompt in-depth examination;
- ② a financial instrument is offered with an unclear risk profile, necessitating an examination of its solicitation activities;
- ③ the actual situation of business operations is not fully comprehended from an information analysis based on off-site monitoring (including where there is a long period between examinations); or
- ④ there is a possible serious problem concerning investor protection (e.g., inadequacy in the segregated management of customer assets).

With regard to unregistered FIBOs, the SESC will actively collect and analyze information, conduct investigations in collaboration with relevant agencies, and seek court injunctions to cease and suspend activities that violate the FIEA so as to contain the spread of damage to investors.

2. Industry-wide and thematic monitoring priorities

The SESC will aim to work closely with the relevant departments of the JFSA to look into and monitor the following as thematic monitoring priorities applied across the industry through appropriate methods required for each theme in accordance with the “*Assessments and Strategic Priorities*.”

- ① Changes to customer service and business models attributable to the coronavirus pandemic
Examples: (i) addressing customers whose investment assets have been affected by significant price fluctuations, (ii) malicious transactions that take advantage of investor anxiety, (iii) the impacts of dramatic environmental changes on financial condition and management, including the sustainability of business models reliant on conventional face-to-face sales, and (iv) examination of the appropriateness of underwriting services in keeping with financing demand
- ② Firm establishment of customer-oriented business conduct prioritizing appropriate investment solicitations based on the clarification of the principle of suitability

For example, while bearing in mind the possibility of inappropriate sales to investors that may arise from excessive sales targets and significant burdens beyond the front-line resources for sales, the SESC will focus on factors which are in the background of such problems, including the status of the establishment of the necessary internal control environments, the intention of management, and insufficient distribution of managerial resources.

- ③ sufficiency of cyber security measures, and the status of risk management in systems that include securities businesses utilizing blockchain
- ④ Firm establishment of internal control environments for AML/CFT
- ⑤ Implementation of measures to improve or prevent the recurrence of matters pointed out in results of internal audits or examinations by self-regulatory organizations (SROs)

In addition to the above, the SESC will flexibly examine FIBOs on other themes in response to changes in the environment surrounding them.

3. Monitoring strategies for various FIBO business models

Based on the previous business year's monitoring results and the impact of the coronavirus pandemic on the securities sector, the SESC will examine a FIBO if the SESC has concerns regarding its violation of relevant laws and regulations or inadequate separate management, taking into considerations the scale of FIBOs' businesses and the type of service. The examination will be conducted with focus on the following points.

(1) Major securities business groups ⁵

The SESC will continue to monitor major securities business groups on a continuous basis with regard to such matters as the development of governance and risk control environments that support domestic and overseas business operations, efforts to establish a sustainable business model, efforts to establish an effective and principle-based compliance environment, efforts to instill and establish customer-oriented business conduct, and efforts to enhance AML/CFT measures. In doing so, the SESC will take into consideration the management environment surrounding each business group.

The SESC will monitor the private placements business, investment business

⁵ Major securities business groups: Japanese securities companies with global operations

risks, and risk management across the group as a whole, including overseas.

For securities businesses under the three mega banking groups, given their intentions to expand their customer bases through banking and securities collaborations, the SESC will monitor their control environments to manage conflict of interests and other control measures, in addition to the points listed above.

Also, the SESC will swiftly conduct on-site monitoring where it is necessary to confirm the actual sales practices at sales offices.

(2) Foreign securities firms

The SESC will monitor the development of internal control environments that respond to the progress of overseas outsourcing of back office operations as part of the group strategy and structural changes in business models.

In light of the prolonged low interest rate environment, the SESC will also examine the trends in finance products sold to Japanese financial institutions and other investors and the risks of these products.

(3) Online securities firms

With online trading becoming increasingly popular, the SESC will examine the status of internal control environments at online securities firms connected with increases in products they offer, and with their launch and expansion of face-to-face sales activities in collaboration with independent financial advisors (IFAs), all the while bearing in mind the group's overall strategy and management policies as well as the synergetic effects gained from collaboration with banks and non-financial groups.

Also, the SESC will continue to examine their implementation of system risk management that covers cyber security.

(4) Semi-major securities firms and regional securities firms

With semi-major and regional securities firms facing a severe business environment made more so by a growing outflow of customer funds through the aging of customers and inheritance as well as by the coronavirus pandemic, the SESC in its inspections heretofore has discovered problematic behavior in terms of investor protection at several firms, including improper solicitations regarding foreign stocks and high-yield financial instruments, and it will continue to rigorously examine this point, including steps taken to conform to the principle

of suitability.

In addition, the SESC will examine the securities firms whose major shareholders or management structure changed due to participation of foreign capital or other investors from the perspective of business model and governance.

(5) Foreign currency margin transactions (FX transactions) business operators

For FX transactions business operators, the SESC will examine their response to the revision of the Cabinet Office Ordinance to strengthen settlement risk management, which includes disclosure of risk information, implementation of stress tests, and a reflection of the results of the stress tests to capital.

(6) Investment management business operators

To ensure that investment management business operators fulfill the duty of loyalty and duty of due care of investors, the SESC will continue examining control environment for the management of conflicts of interests and outsourced investment management.

The SESC will also examine the systems put in place to ascertain fair market values, and continue to ascertain the status of investments in alternative assets.

(7) Investment advisors/agencies

The SESC will examine whether or not any misleading advertisements are used, or if any solicitation activity is conducted using false explanations based on the past monitoring result.

(8) Type II FIBOs and QII business operators

For Type II FIBOs (including sellers of loan-type funds) and QII business operators, the SESC will conduct monitoring with a focus on funds advertising high returns and the actual existence of the business project in which investment is to be made. In addition, the SESC will conduct risk-based examinations through the analyses of information provided by investors and other sources.

(9) Other securities businesses subject to monitoring pursuant to the FIEA

For other securities businesses, including securities finance firms, credit rating agencies, registered financial institutions, and SROs, the SESC will conduct

risk-based monitoring in light of the firm's particular business type.

(10) Unregistered business operators

To prevent damage to investors caused by unregistered business operators, the SESC will strengthen cooperation with the JFSA's Supervisory Bureau, LFBs, Consumer Affairs Agency and other investigative authorities. Where appropriate, the SESC will exercise its investigative authority to seek court injunctions that will force these firms to cease and suspend their activities that violate the FIEA.

The SESC will also continue to take strict actions, including public disclosure of the firms' names, the names of their representatives, and the nature of their illegal conduct.

The SESC will examine operations pertaining to high-speed trading carried out by Type I FIBOs, looking at internal control environments for brokerage businesses, including the order management and system management environments designed to prevent erroneous orders and abnormal operations, as well as order execution, trading control, etc., across multiple markets: stock exchanges, private trading systems (PTS) and dark pools.

With regard to operations involving cryptoasset derivatives, security tokens, commodity futures, etc., for which laws/regulations were put in place through revisions to the FIEA, the SESC will analyze information in collaboration with the relevant bureaus of the JFSA and examine these operations in line with the risk characteristics of each business category.

4. Cooperation with relevant organizations

The SESC will work closely with LFBs through direct communication from the planning stage of both off-site and on-site monitoring, including information sharing, and also conduct joint examinations as needed in order to maximize their respective functions. If a case that involves multiple LFBs occurs, the SESC will exercise its guidance and coordination functions by, for instance, determining ways to collect and share information and considering appropriate monitoring methods. It will also focus on the necessary training to support such activities of LFBs and others.

The SESC will also continue collaborating closely with SROs and share the matters

detected and current perspectives on issues as needed by exchanging information in a timely manner. By doing so, the SESC conducts the efficient monitoring of securities businesses and will contribute to ensure market fairness and transparency as well as protect investors.

5. Dissemination of monitoring results and other initiatives

The SESC will encourage voluntary improvement efforts by providing FIBOs with feedback on problems and their root causes found in the monitoring of securities businesses, and sharing the monitoring results with parties related to such audits and outside directors at the time of review, in cooperation with the relevant departments of the JFSA if necessary.

The SESC will also endeavor to provide the public with more information about the results of its monitoring of securities businesses in a specific and straightforward manner as a way to help market participants correctly understand the SESC's perspectives on issues requiring attention, including the publication of the "*Overview of Monitoring of Securities Businesses and Case Studies*."