

Basic Principles of Securities Business Monitoring

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Securities and Exchange Surveillance Commission

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Basic Principles of Securities Business Monitoring

The Securities and Exchange Surveillance Commission (hereinafter, the "SESC") compiled the basic principles of monitoring of financial instruments business operators (FIBOs) (securities monitoring) in this document, together with other relevant documents, in light of guidelines and policies already publicized by the Japan Financial Services Agency (JFSA).¹

I. Current Status and Problems of Securities Business Monitoring

1. SESC's Past Initiatives

(1) seamless on-site and off-site monitoring based on risk based approach

The SESC has properly ascertained the status of FIBOs, such as the effectiveness of their business management and governance, characteristics of their business including the financial instruments they deal in and their transactions, the appropriateness of their risk management, and their financial conditions, through collaboration with competent supervisory departments, and has conducted seamless on-site and off-site monitoring in accordance with the particular risks faced by a total of over 7,000 FIBOs.

In on-site monitoring in particular, the SESC ascertains the whole picture of the problems and investigates their root causes, thereby making efforts for in-depth examinations that will lead to the prevention of recurrence.

(2) Policies that the SESC has established

In order to conduct the seamless on-site and off-site monitoring mentioned in (1) above, the SESC has established and publicized the following policies and guidelines, and it has been conducting securities business monitoring based thereon, pursuant to the provisions of the Financial Instruments and Exchange Act and other relevant laws and regulations:

(i) Strategy & Policy of the SESC

SESC's course of action for three years in light of the environment surrounding the Commission

(ii) Monitoring Priorities for Securities Businesses

Compilation of matters to be prioritized in monitoring of securities businesses for each business year in light of the economy and market environment of the time

(iii) Inspection Manual for Financial Instruments Business Operators (Securities

¹ Securities monitoring 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, other than on-site inspections, carried out by the SESC mainly in collaboration with competent supervisory departments, which include information gathering through collection of reports from and meetings with FIBOs, etc.

Inspection Manual)

Manual for inspectors that specifically illustrates points to focus on and matters to note in on-site monitoring

(iv) Securities Monitoring Guidelines

Guidelines mainly on procedures for on-site monitoring

2. Challenge of SESC's Securities Business Monitoring

As mentioned above, the SESC is conducting seamless on-site and off-site monitoring, in collaboration with competent supervisory departments. However, since June 2018, the JFSA has recast its existing supervisory approach.^(Note) Against such a background, it is urgently required to clarify and share points to focus on and matters to note in inspections and supervision in order to further enhance the effectiveness and efficiency of the SESC's securities business monitoring.

The following shows the basic principles and approaches concerning the SESC's securities Business Monitoring, including the relations between its policies and guidelines and the JFSA's Supervisory Approaches, Comprehensive Guidelines for Supervision, discussion papers, etc.

(Note) The JFSA's Supervisory Approaches

In June 2018, the JFSA prepared and publicized the "JFSA's Supervisory Approaches," which provides for basic principles and approaches for conducting inspections and supervision of all targeted financial institutions, and presented the following approaches.

- As conventional periodic inspections cannot make timely responses to changes in the business environment or new issues that may arise during the interval of periodic inspections, the JFSA is shifting towards a seamless monitoring approach consisting of risk-profiling of individual financial institutions based on continuous information gathering and flexible use of on-site inspection and off-site monitoring depending on the nature of the issues in question, and seamless monitoring of progress made by firms.
- As means for inspections and supervision, the JFSA adopts the new supervisory approaches based on the following three pillars: the enforcement of minimum standards² to check compliance with common minimum standards; the dynamic supervision to secure continued soundness; and the promotion of disclosure and engagement with financial institutions aimed to encourage financial institutions' pursuit of best practices.
- Regarding specific themes and fields (compliance risk management, customer-oriented business conduct, IT governance, prudential policy, etc.), principles and discussion

² Minimum standards include various laws and regulations established for the purpose of ensuring consumer protection and market integrity and transparency, and systems that are the minimum requirements for business administration, customer protection and risk management.

papers to be used in dialogues with financial institutions are to be utilized together with Comprehensive Guidelines for Supervision.

II. Securities Business Monitoring In Future

1. Basic Principles

The SESC will continue strict examinations as to whether FIBOs are properly performing their businesses based on laws and regulations.

On that occasion, the SESC not only investigates cases of violations of laws and regulations but ascertains the whole picture of the problems, including the likelihood of non-compliance with minimum standards in the future, investigates their root causes, and conducts examinations from a forward-looking perspective, continuously focusing on the status of FIBOs' systems for business operations (business management system, internal control system and legal compliance system, risk management system, internal [external] audit system, and crisis management system).³

In particular, regarding FIBOs belonging to a financial group, etc., the SESC conducts monitoring from a multifaceted perspective, covering the business models and business policies of the relevant financial group as a whole, in collaboration with competent supervisory departments.

2. Approaches for Monitoring

(1) Rule-based examinations

The Financial Instruments and Exchange Act, and other relevant laws and regulations, provide with minimum necessary rules that FIBOs should observe in order to ensure market integrity and transparency and investor protection. The SESC will continue strict examinations as to whether FIBOs are properly performing their businesses based on the Financial Instruments and Exchange Act, and on other relevant laws and regulations. On that occasion, when applying specific provisions, the SESC takes into account significant interests that should be protected by laws in light of the purport and purpose of laws and regulations.

³ Regarding the abovementioned five systems for business operations stated in the Securities Inspection Manual, whether FIBOs have sufficiently developed them or not is important for investigating root causes of their problems and assessing the likelihood of their non-compliance with minimum standards in the future. Therefore, these five systems for business operations remain to be the points to focus on in securities inspections.

(2) Systems for business operations for investigating root causes and assessing the likelihood of non-compliance with minimum standards in the future

When investigating root causes of detected violations of laws and regulations or assessing the likelihood of non-compliance with minimum standards in the future, the SESC examines the appropriateness of FIBOs' systems for business operations based on Comprehensive Guidelines for Supervision publicized by the JFSA,⁴ and also on concepts and approaches indicated in the "JFSA's Supervisory Approaches", principles, and theme-specific discussion papers.

For example, with regard to "JFSA's Supervisory Approaches", the following concepts should be considered, depending on the details of each case:

- It is important to discuss effective remedial measures toward the future through investigating root causes of problems, and to assess whether FIBOs' governance, corporate culture, and internal control system as a whole have the effectiveness as required.
- Even though no problems in relation to consumer protection or unfair trade are found at present, if it is likely that a problematic event may occur in the future due to such reasons as a financial institution's business model, the socioeconomic environment, regulatory trends, and heightened expectations of society, the financial institution is highly likely to breach minimum standards in the future.

(3) Monitoring priorities for each business year

The SESC is to decide policies and priorities for monitoring from a forward-looking perspective, in consideration of changes in the economic environment, etc. surrounding FIBOs, in the Strategy & Policy of the SESC and the Monitoring Priorities for Securities Businesses, while referring to the Summary Points from Strategic Directions and Priorities, etc.⁵ publicized by the JFSA.

(4) Monitoring procedures

For inspection procedures, the Securities Monitoring Guidelines should be utilized continuously.

⁴ Other Comprehensive Guidelines for Supervision include "Guidelines for Supervision of Credit Rating Agencies," "Guidelines for Supervision of High Speed Traders," and "Comprehensive Guidelines for Supervision of Financial Market Infrastructures - Clearing Organizations, Fund Clearing Organizations, Book-entry Transfer Institutions, and Trade Repositories -," as well as the "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism."

⁵ For example, in FY2019, "Financial Services Policy: Assessments and Strategic Priorities 2019" (publicized on August 28, 2019)

3. Status of the Securities Inspection Manual

(1) Current situation⁶

The Securities Inspection Manual⁷ established in 2001 consists of the Structures and Systems Part focusing on FIBOs' systems for business operations and the Business Operations Part listing inspection items concerning compliance in line with FIBOs' operational processes. The SESC has utilized this manual mainly as a guide for inspectors.

The content of the Structures and Systems Part mostly overlaps with the Comprehensive Guidelines for Supervision. Additionally, regarding the Business Operations Part, uniform examinations using the checklist contained in the Securities Inspection Manual seem to have lost significance, as examinations depending on risks faced by respective FIBOs have come to be required under the current circumstances in which FIBOs' transactions and business models are becoming more and more complicated and diverse.

(2) Abolition of the Securities Inspection Manual

Based on the abovementioned current situation, the content of the Structures and Systems Part of the Securities Inspection Manual is to be succeeded to the Comprehensive Guidelines for Supervision, including the approaches necessary for examinations of FIBOs' business operations while conducting seamless on-site and off-site monitoring.

The Business Operations Part is to be abolished⁸ because there is the risk that operational processes following the descriptions in this part may lead to prioritizing only formality, and in the first place, each FIBO should independently decide its own workable administrative procedures in accordance with the size and characteristics of its business.

The abovementioned handling of the Structures and Systems Part and the Business Operations Part of the Securities Inspection Manual will be enforced immediately at the same time as this paper is publicized

Policies and guidelines, etc. concerning monitoring of FIBOs after the abolition of the Securities Inspection Manual are as shown in the Attachment.

⁶ The JFSA abolished the Inspection Manual for Deposit-Taking Institutions and the Inspection Manual for Insurance Companies, etc. in December 2019.

⁷ Originally, it was established and publicized as the "Inspection Manual for Securities Companies" in June 2001 and has survived with the title changed to the "Securities Inspection Manual" and the "Inspection Manual for Financial Instruments Business Operators."

⁸ The "Inspection Manual for Credit Rating Agencies," a supplement to the "Inspection Manual for Financial Instruments Business Operators," is also abolished.

Date of Enforcement

Established on June/26, 2020

(Attachment)

Policies and Guidelines, etc. Concerning Monitoring of FIBOs after the Abolition of the Securities Inspection Manual

[Established by the SESC]

- Basic Principles of Securities Business Monitoring
(Established on June/26, 2020)
- Securities Monitoring Guidelines
(Established on July 14, 2005)

- Strategy & Policy of the SESC 2020-2022
(Established on January 24, 2020)
- Monitoring Priorities for Securities Businesses (July 2020-June 2021)
(Established on August 4, 2020)

[Established by the JFSA]

- JFSA's Supervisory Approaches
(Established on June 29, 2018)

(Comprehensive Guidelines for Supervision, etc.)

- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.
(Established on September 30, 2007)
- Guidelines for Supervision of Credit Rating Agencies
(Established on April 1, 2010)
- Guidelines for Supervision of High Speed Traders
(Established on December 27, 2017)
- Comprehensive Guidelines for Supervision of Financial Market Infrastructures - Clearing Organizations, Fund Clearing Organizations, Book-entry Transfer Institutions, and Trade Repositories -
(Established on December 10, 2013)
- Comprehensive Guidelines for Designated Dispute Resolution Organizations
(Established on August 2, 2013)
- Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism
(Established on February 6, 2018)

(Discussion papers, etc.)

- Concept and Approaches Concerning Inspections and Supervision of Compliance Risk Management (JFSA's Approach to Compliance Risk Management)
(Established on October 15, 2018)
- Concept and Approaches Concerning Inspections and Supervision for Stabilizing the Financial System (Basic Principles of Prudential Policy)
(Established on March 29, 2019)
- Discussion Paper on Dialogues and Practices Regarding Financial Institutions' IT Governance
(Established on June 21, 2019)
- Current Status and Challenges for Sophistication of Financial Institutions' Internal Audit
(Established on June 28, 2019)

- Principles for Customer-Oriented Business Conduct
(Established on March 30, 2017)

- Assessments and Strategic Priorities 2019
(Established on August 28, 2019)