



# Recent development of Securities Inspections

---

\*Basic Inspection Policy and Program for  
BY2011-12

\*Amendment of Inspection manual

Shuichi Sonoda  
Director, Inspection Division  
SESC  
17 May 2011

# I-1 Basic Inspection Policy for BY2011-12

---

(Published 8 Apr, 2011)

## Background

- Significant increase in both number and variety of regulated firms  
(e.g. Fund dealers, CRAs, non-registered dealers)
- Lessons from the global financial crisis  
--> financial soundness and risk management of large securities firms groups should be emphasized
- IT development on trading platforms  
(e.g. transactions by internet, algorithmic and HFT)
- Damages by illegal non-registered dealers  
--> make use of Article 192 and 187 of the FIEA in response to "Consumer Basic Plan" issued Mar 2010
- Pay attention to the aftermath of the earthquake  
--> suspend inspection of firms coping with the disaster  
--> reinforce surveillance on illegal activities in the confusion

## I-2 Basic Inspection Policy for BY2011-12

---

### Basic inspection policy

1. Toward efficient and effective inspection
  - 1) Risk based inspection
    - Prioritize target firms taking into account monitoring information and information from the public
    - Identify focus areas on each inspection
  - 2) Effective inspection
    - Prior notice inspection
    - Assessment on internal control
      - examine the relevant internal control function behind individual problems
      - a forward looking assessment on a large and complex securities group
    - Further interactive dialogue
      - More interactive dialogue with a management that is responsible for the internal control function.

## I-3 Basic Inspection Policy for BY2011-12

---

### 3) Enhance cooperation with;

- Supervisory Department to seek seamless supervision between on-site and off-site
- Inspection Division of the FSA in case of inspection of a financial conglomerate group
- Self Regulatory Organizations (SROs) by means of coordinating inspection programs, exchanging information and joining training programs
- Overseas Regulators concerning inspection on Japanese entities of foreign securities firms, overseas entities of domestic firms and contribution for supervisory colleges
- Investigative Authorities for revelations against non-registered dealers

### 4) Revision of the Inspection Manual

- On 1 April, 2011, check points for assessment on the internal control function of large securities groups have been introduced (see appendix)

## I-4 Basic Inspection Policy for BY2011-12

---

### 2. Focused areas for inspection

#### 1) Role as a gatekeeper

##### i) market intermediary functions, such as:

- \* customer management (to prevent anti-social forces) by means of enhancing collecting information, reporting of suspicious transactions, and customer identification (impersonation)
- \* reviewing function for securities underwriting

##### ii) management of undisclosed corporate information

##### iii) reviewing function of any activities which may hinder fair pricing

- \* screening of possible unfair transactions especially by focusing on the pricing day in public stock offering, just before closing of a market, and frequent large orders
- \* compliance with regulations on short selling: disclosure requirement, regulation of price, prohibition against naked short selling
- \* internet transactions ("Misegyoku" case conducted by retail investors)

## I-5 Basic Inspection Policy for BY2011-12

---

### 2) Internal control function

#### The SESC

- i) reviews group-wide internal control function from forward-looking perspective to a securities group which conducts large and complex business
  
- ii) reviews control function of IT systems: preventing wrong orders, IT troubleshooting, IT security control, oversight on outsourcing

## I-6 Basic Inspection Policy for BY2011-12

---

### 3) Investor protection

#### i) review solicitation practice:

- \* suitability rule
- \* explanation of significant conditions on soliciting switching transactions of investment trusts
- \* explanation of OTC derivatives risk

#### ii) Investment management firms

- \* duty of loyalty
- \* Due Care of a Prudent Manager
- \* control over conflicts of interest

## I-7 Basic Inspection Policy for BY2011-12

---

### iii) Fund dealers

Many serious legal violations were found in the recent inspections.

-->> The SESC will continue risk-based inspections, including those of firms conducting Specially Permitted Businesses for Qualified Institutional Investors, etc.

### iv) Investment advisories

Many serious legal violations were found during the recent inspections.

-->> The SESC will continue risk-based inspections.

### v) Non-registered dealers

-->> The SESC shall employ an Article 192 petition and an Article 187 investigation and closely cooperate with the FSA supervisory bureau and investigators.



## I-8 Basic Inspection Policy for BY2011-12

---

### 4) Other issues

#### i) SROs

--> examination for initial listing, listing control, transaction assessment, and IT system risk management

#### ii) Credit Rating Agencies

--> assessing business control systems with reference to the Inspection Manual (published 31 March, 2010)

#### iii) surveillance of an unfair transaction by which one party took advantage of a recent disaster

--> thorough surveillance under cooperation with relevant sections

## II-1 Basic Inspection Plan for BY2011-12

---

### Concept

- 1) Regarding firms which underwrite, trade and solicit for financial instruments with a high level of liquidity, such as listed securities, firms that manage assets on commission from investors for the interests thereof, and Credit Rating Agencies  
--> The SESC will examine the status of their management of business operations and the financial soundness continuously.
- 2) Regarding firms other than those specified in i) above (e.g., firms which deal with financial instruments with a low level of liquidity or which only conduct investment advisory business)  
--> The SESC will prioritize firms to be inspected, based on the analysis of information collected from the supervisory department in light of the extremely large number of firms subject to inspection.
- 3) Non-registered firms  
--> The SESC will analyze information provided by the public and investigate for a petition of court injunction.

## II-2 Basic Inspection Plan for BY2011-12

Types of firm	2007	2008	2009	2010	2011 plan
Type I financial business firms, etc.*1 (by the SESC) (By the LFBs)	138 (55) (141)	157 (34) (123)	132 (36) (96)	140 (34) (106)	On-going basis (--) (--)
Investment advisories, etc. *2	24	59	70	On-going basis	On-going basis
SROs	1	5	5	As necessary	As necessary
Non-registered firms					On-going basis

\*1 Type I Financial Business Operators (including Registered Financial Instruments Operators), Asset Management firms, and Credit Rating Agencies.

It is hard to estimate the number of target firms because of the recent disaster.


\*2 Investment Advisories and Agencies, Type II Financial Instruments Business operators and financial instruments intermediaries, etc.



## III. 5 Points to be aware of

---

1. Involvement of board members for the compliance issue: critically important
2. Both resources and power are necessary for the compliance and internal control department
3. Completion of an improvement cycle;  
trouble occurs --> respond and analyze --> preventive measure --> assessment
4. Keep up with changes: trends of regulatory change (including self regulation), inspection findings (compliance standard is also improving)
5. From “compliance” to “discipline”



---

ご清聴ありがとうございました。  
またいつかお会いしましょう。

Thank you for your attention.  
See you again.

The end.

## Appendix) Summary of revision of the Inspection Manual (1 April, 2011)

---

Assessment on internal control function of securities groups which conduct large and complex business collaborating with group member firms

Lessons from the global financial crisis:

A bankruptcy of an investment bank

--> Insolvency of a whole group

-->> Spread to other market intermediaries

-->>> global financial turmoil

--> Large securities companies are required to conduct consolidated and effective group-wide risk management.

(JFSA has introduced consolidated regulation and supervision on large securities groups since April 2011.)

--> The SESC will assess consolidated risk management with a forward looking perspective.

## Appendix) Summary of revision of the Inspection Manual (1 April, 2011) 2

---

Target of the above inspection:

- \* A group in which a special financial instruments business operator (Type I financial instruments business operator with more than a certain value of total assets) conducts a significant business that may influence the whole group
- \* A Japanese entity of a foreign securities group which has a certain level of staff and assets and conducts extensive business in Japan

## Appendix) Summary of revision of the Inspection Manual (1 April, 2011) 3

---

### Considerations for using the Manual

- \* It's not necessary to fulfill all the check points.
- \* Inspectors should understand the business of the firm and hold active dialogue rather than apply the check points to every firm automatically or standardize inspection.
- \* Keep in mind that securities firms may have different business models and risk profiles and may require different risk management than that of banks.



## Appendix) Summary of revision of the Inspection Manual (1 April, 2011) 4

---

### Risk categories:

- \* Market risk
- \* Liquidity risk
- \* Credit risk
- \* Operational risk
- \* IT system risk
- \* consolidated risk
- \* Internal audit

### Framework:

- \* PDCA cycle
  1. set directions
  2. develop rules and structures
  3. assess and improve its effectiveness

## Appendix) Summary of revision of the Inspection Manual (1 April, 2011) 5

---

### (e.g.) Market risk management

1. Set directions
  - set a management policy and share it with all employees
2. Develop rules and structures
  - develop internal rules and procedures
  - set up organization and operation
  - determine the limit
  - monitor market risks
3. Assess effectiveness and make improvements
  - assess operation of market risk management
  - improvement