Tentative translation : Only Japanese text is authentic

November 14, 2017

Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2017–June 2018)

Introduction

The missions of the Securities and Exchange Surveillance Commission (SESC) are: (1) Ensuring market integrity/protection of investors, (2) contributing to 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 businesses[1]) is to ensure investors' confidence in the markets. For this purpose, the SESC encourages FIBOs to enhance self-discipline to perform their function as market intermediaries and operate properly in compliance with relevant laws, regulations and market rules.

In the *"Strategy & Policy of the SESC 2017-2019,"* released in January 2017, the SESC cited "effective risk-based monitoring of regulated entities" as one of the concrete measures to fulfill the missions for the period. For this measure, the SESC has been collaborating with relevant departments of the Financial Services Agency (JFSA).

This document outlines the principle approach to monitoring FIBOs and sets forth the areas of focus in the monitoring activities, in the 2017–2018 business year.

1. Monitoring Priorities for Securities Businesses

(1) General environment surrounding securities businesses

Not much expansion has been seen in the customer base of securities businesses, with the majority of Japan's household financial assets still held in the form of cash or deposits. The customer base is aging, making it an important management issue for securities businesses to develop sustainable business models, for example, changing main selling products.

Under such circumstances, some securities businesses aim to expand their customer base by aggressively promoting businesses in collaboration within

[1] 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 made notification for business specially permitted for qualified institutional investors, credit rating agencies, and so on.

their groups, which increases the risk of potential conflict of interest. Others have significantly changed their business strategies under the stricter financial regulations around the world and the changing market environment.

Cybersecurity measures and Fintech businesses have become an important management issue.

(2) Approach to monitoring securities businesses

Securities businesses subject to monitoring by the SESC currently total approximately 7,000, and these firms offer an increasingly diverse and complex set of services and products. They include businesses that do not fully establish basic controls to comply with relevant laws and regulations in order to protect investors.

Therefore, it is essential to make best efforts to conduct effective and efficient monitoring of securities businesses and identify risks that could undermine investors' confidence.

Since the last business year, the SESC has introduced a strategy of selecting the businesses subject to on-site monitoring based on the off-site risk assessment on all securities businesses. The assessment contains the analysis of business environment covering economic and industrial trends and the entity's business model. The SESC will continue to implement this strategy in the current business year.

In conducting on-site monitoring, the SESC aims to not only point out legal problems but also analyze the whole picture of the problems to identify root causes, so that businesses can address them and prevent recurrence.

Where identifying the need for improvement of management systems or other potential issues which may not necessarily have become materialized problems, the SESC will share the findings with the subject of the on-site monitoring and encourage them to build an effective internal control system or address issues.

(3) Activities in the last business year

The SESC focused particularly on not only risk assessment of entities' business models, but also both the effectiveness of their governance and the appropriateness of their risk management in light of their business models.

The SESC especially looked into operations of securities or investment management businesses in line with their operational scale and characteristics, with a focus on their governance and risk-control structure as it relates to the three lines of defense, by analyzing the submitted documents and holding dialogues with them. As a result, the SESC identified issues such as the need for more active engagement of directors in discussions at board meetings and enhancement of the oversight functions of outside directors at securities companies. On the other hand, some investment management business operators were found to need improvement in their control of conflict of interest.

As there are large numbers of Type II FIBOs, investment advisors/agencies, and persons made notification for business specially permitted for qualified institutional investors (QII business operators), the SESC strived to identify problems as early as possible by extracting high risk businesses and carrying out on-site monitoring on them based on the analysis of risks associated with their products and tips provided by outside sources.

(4) Policy for activities in the current business year

The SESC will utilize accumulated knowledge from last business year's activities and focus more on changes in the business model of each company. In its risk assessment of securities businesses, the SESC will make efforts to identify potential issues and also narrow down monitoring area for which its review has been deemed necessary.

The SESC will aim to conduct on-site monitoring to clarify details in cases where any of the following situations are identified:

① Violations of relevant laws and regulations or internal control deficiencies that need immediate attention

② Solicitation for financial instruments with unclear risk profile

③ Possible serious problems concerning protection of investors (e.g., segregated management of customer assets is not ensured).

2. Industry-wide and thematic monitoring priorities

In monitoring securities businesses, the SESC will aim to work closely with relevant departments of the JFSA to look into the following as thematic monitoring priorities applied across the industry, proceeding in accordance with the "*Strategic Directions and Priorities*[2]".

① Customer-oriented business conduct

② Cybersecurity

③ Trade surveillance of High Frequency Trading

④ AML/CFT (Anti-Money Laundering/Counter Financing of Terrorism)

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

[2] The JFSA released the 2017-2018 Strategic Directions and Priorities on Nov. 10, 2017.

3. Monitoring strategies for various FIBOs business models

In accordance with the "*Strategic Directions and Priorities*", the SESC will mainly look into the following aspects of FIBOs based on their scale of operations and type of service.

(1) Large securities business groups (i.e., Japanese securities companies with global operations)

- Business trends in Japan and abroad, and changes in their business models
- Appropriateness of risk and compliance management systems in light of their business models
- Viability of governance, including effectiveness of internal audits and IT
- Management of conflict of interest (for securities businesses under the three mega banking groups, as they are seeking to expand their customer base through collaboration between banking and securities operations)

(2) Foreign securities firms

- Changes in business models, profit structure and risk profile at a base in Japan as they relate to changes in their global strategies in response to amendments of international financial regulations.
- Effectiveness of internal control, in view of observed moves to enhance efficiency through outsourcing internal control operations to overseas entities.

(3) Securities companies, other than those described above

- Effectiveness of governance to ensure appropriate operation in light of changes in profit structures and new services introduced, especially at traditional face-to-face securities business model, in view of the aging of their customer base.
- Sufficiency of risk assessment of newly introduced products and appropriateness of solicitation and sales practices in light of the principles of suitability, in view of observed moves to exit from a profit structure relying on brokerage fee revenues and diversify revenue sources.
- Changes in governance structures and business models in case a firm's capital structure changes significantly.

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

- Measures to protect investors as a precaution against occurrence of events that can significantly affect the foreign exchange market
- Risk management system of FX transactions business operators

(5) Investment management business operators

- Effectiveness of management of conflict of interest, product development processes and portfolio liquidity management for funds
- Effectiveness of management of investment products

(6) Investment advisors/agencies

- Misleading advertisements
- Solicitation by deceptive means

(7) Type II FIBOs

- Substance of businesses that receive investment from the funds they handle and the management of money invested in funds
- Misleading advertisements

(8) QII business operators

- Substance of invested businesses and management of money invested in funds

In particular, the operations since March 1, 2016, when the amended Financial Instruments and Exchange Act (FIEA) took effect, will be focused on.

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

For other securities businesses, including registered financial institutions, credit rating agencies, financial instruments intermediaries, and self-regulatory organizations (SROs), the SESC will conduct risk-based monitoring in light of the firm’s particular business types.

(10) Unregistered business operators

In order to prevent damage to investors from unregistered business operators, the SESC will strengthen cooperation with the JFSA’s Supervisory Bureau, Local Finance Bureaus, and other investigative authorities. Where appropriate, the SESC will exercise its investigative authority to seek court injunctions to force these firms to cease or suspend activities that violate the FIEA. The SESC will also continue to take strict actions, including public disclosure of their names, the names of their representatives, and the nature of their illegal conduct.

4. Cooperation with Local Finance Bureaus and other relevant organizations

The SESC will collaborate closely with Local Finance Bureaus (LFBs). If the jurisdiction falls over multiple LFBs, the SESC will strive to enhance its guidance and coordination functions, working out ways to collect information, share analytical results with relevant LFBs and consider appropriate monitoring methods.

The SESC will continue to work closely with SROs, including by sharing information and perspectives on problems with them to raise the efficiency of monitoring programs and to ensure fairness and transparency in the markets.

5. Feedback to entities subject to monitoring

Problems, as well as best practices for other FIBOs, found through monitoring will be fed back to individual FIBOs, in cooperation with relevant departments of the JFSA if necessary, in order to encourage their voluntary efforts.

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