

September 14, 2018

Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2018-June 2019)

Introduction

The missions of the Securities and Exchange Surveillance Commission (SESC) are: (1) ensuring market integrity and transparency / 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 businesses¹) is to ensure investors' confidence in the markets. For this purpose, the SESC encourages FIBOs² to enhance self-discipline to perform their function as market intermediaries and to operate properly in compliance with relevant laws, regulations, and market rules.

In "*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 mission for the period. For this measure, the SESC has been collaborating with relevant departments of the Financial Services Agency (JFSA).

This document outlines the basic monitoring policy for FIBOs and sets forth the areas of focus in the monitoring activities, in the 2018-2019 business year.

1. Monitoring Priorities for Securities Businesses

(1) General environment surrounding securities businesses

The global economy continues to recover gradually. However, signs of change, which include the normalization of the extraordinary monetary easing measures

¹ "Monitoring of securities businesses" in this document includes both on-site and off-site monitoring. On-site monitoring means inspections conducted on 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 notifying engaging in business specially permitted for qualified institutional investors, credit rating agencies, and other entities.

adopted after the global financial crisis and sharp declines in the previously firm share prices, are beginning to show in Europe and the U.S.

The Japanese financial capital markets have seen slowdown in the increase of share prices and share trade volume, although share prices still remain at high levels. Interest rates continue to remain at historically low levels.

These circumstances make it difficult for FIBOs to secure earnings under the traditional business models that rely on fee income. Some investors' move to pursue products with higher returns was abused in a case where a FIBO's sale of high-risk products to individual investors without sufficient explanations on risks subsequently materialized as problems, and a case where unregistered business operator lured investors by the promise of high returns and caused damage.

Cyberattacks continue to be a threat to FIBOs. In July 2017, a large volume of personal information was leaked due to cyberattacks targeting a website operated by a foreign currency margin transactions business operator.

(2) Approach to monitoring securities businesses

Securities businesses subject to the SESC's monitoring currently total approximately 7,000. These firms offer an increasingly diverse and 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 best efforts to conduct effective and efficient monitoring of securities businesses and to promptly identify risks that could undermine investors' confidence based on the risk characteristics of FIBOs and with the limited human and other resources.

The SESC will continue implementing a strategy of selecting the businesses subject to on-site monitoring based on the off-site risk assessment of all securities businesses. The SESC carries this out in collaboration with the relevant bureaus of the JFSA including an analysis of the business environment covering economic and industrial trends and an entity's business model.

In conducting on-site monitoring, the SESC aims to not only point out problems and to take actions such as to make 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 their recurrence.

Furthermore, if the need to improve business operations or other potential issues are identified before any problem materializes, the SESC will share the findings with the monitored business 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, the SESC conducted off-site monitoring focusing on changes in the business models of FIBOs. The SESC identified potential issues as the themes to be examined and reviewed the actual conditions through on-site monitoring where it was necessary to comprehend further details.

As a result of this approach, the SESC identified a case where a securities company, who is required to sufficiently examine risks and other characteristics of a new product and create an appropriate control environment for solicitation and sales before its launch, had discovered inadequacies in their screening practices and inappropriate solicitation and sales activities only after risks had materialized. The SESC also identified cases that some securities companies had problems with control environments for basic compliance.

With respect to investment management business operators, the SESC examined, among other things, their approach to customer-oriented business conduct, control environments for conflict of interest management and the effectiveness of liquidity management for assets included in funds, with a focus on major investment management business operators.

With respect to Type II FIBOs, investment advisors/agencies, and persons notifying engaging in business specially permitted for qualified institutional investors (QII business operators), the SESC identified high risk businesses from among the large number of businesses falling under these categories and carried out on-site monitoring as needed based on the analysis of risks associated with their products and information provided by outside sources. As a result of the on-site monitoring, the SESC found problematic cases in terms of investor protection; for instance, some businesses had made false or misleading representations on their websites.

Furthermore, the SESC sought court injunctions to force the cessation and suspension of activities of unregistered businesses that caused a large amount of damage to general investors through their investment advisory services or solicitation for investment in funds.

(4) Policy for activities in the current business year

As it is becoming increasingly difficult for the traditional fee income-dependent business model to secure earnings in the Japanese financial capital markets,

FIBOs have begun changing their business models. They do so by, for instance, starting new businesses and expanding their product lineups to include overseas financial products and higher-return funds in response to investor expectations for higher-return products.

In light of this situation, in the current business year, the SESC will assess risks focusing on the afore-mentioned trend. In particular, the SESC will proactively conduct on-site monitoring for in-depth examinations where it is necessary to comprehend further details in the event:

- 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); and
- ④ there is a possible serious problem concerning investor protection (e.g. inadequacy in the segregated management of customer assets).

Furthermore, the SESC will actively collect and analyze information on businesses that carry out financial instruments exchange business without proper registration, conduct investigations in collaboration with relevant agencies, and seek court injunctions to cease and suspend activities that violate the Financial Instruments and Exchange Act (FIEA) so as to contain the spread of damage to investors.

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 in accordance with the “*Strategic Directions and Priorities.*”

- ① AML/CFT (Anti-Money Laundering/Combating the Financing of Terrorism) measures
- ② Sufficiency of cyber security measures
- ③ Implementation status of measures to realize customer-oriented business conduct
- ④ Efforts to upgrade trade surveillance of High Frequency Trading

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

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) Major securities business groups³

The SESC will continue sustained monitoring on the organization status of governance and control environments for risk management that support global business operations and efforts to establish a sustainable business model. In addition, the SESC will swiftly conduct on-site monitoring where it is necessary to confirm the actual sales practices at sales offices.

For securities businesses under the three mega banking groups, given their intention to expand their customer bases through banking and securities collaboration, the SESC will also monitor their control environments for conflict of interest management in addition to the above.

(2) Foreign securities firms

The SESC will continue sustained monitoring on the impact of international financial regulations on the business models of the Japanese offices of foreign securities firms and changes in their control environments for risk management. In addition, the SESC will monitor whether foreign securities firms have internal control environments in place that accurately respond to Japanese laws and regulations, given the growing trend of outsourcing internal control operations overseas as part of group strategy.

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

(3) Online securities firms

The SESC will examine online securities firms’ efforts to prevent system

³ Major securities business groups: Japanese securities companies with global operations

errors and to ensure speedy recovery and to provide alternative means for service delivery upon occurrence of errors. In addition, the monitoring will cover changes in product offerings and the status of control environments in preparation for the launch and expansion of face-to-face sales activities in collaboration with independent financial advisors (IFAs) and regional financial institutions.

(4) Second-tier securities firms, regional securities firms

The SESC will examine, among other things, the organization status of business operations in response to changes to each firm's product lineup and profit structure, against the background of the outflow of customer funds through the aging of customers and inheritance. In addition, the SESC will examine the impact any change to the management structure or major shareholders may have on the business models of these securities firms.

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

The SESC will examine the sufficiency of investor protection measures against foreign exchange fluctuations. In addition, the SESC will examine the control environments for settlement risk management of FX transactions business operators including their preparation status for improving capital adequacy through stress testing and for improving their transaction data reporting system.

(6) Investment management business operators

The SESC will examine the effectiveness of governance functions, control environments for management and other points of monitoring from aspects such as improving the investment management abilities of investment management business operators, particularly concerning large operators. In addition, the SESC will examine the business operations of private REIT operators and discretionary investment management business operators with a high proportion of individual and pension fund customers, from aspects such as the management of conflicts of interest and liquidity risk management.

(7) Investment advisors/agencies

The SESC will examine whether any misleading advertisements are used or if any solicitation activity is conducted using false explanations.

(8) Type II FIBOs and QII business operators

For Type II FIBOs (including social lending business operators) and QII business operators, the SESC will conduct monitoring with a focus on funds advertising high returns and actual existence of business project to be invested. In addition, the SESC, based on the aforesaid monitoring and the analysis of information provided by investors and other sources, will promptly conduct on-site monitoring on operators who are deemed high risk.

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

For other securities businesses, including registered financial institutions, credit rating agencies, 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

To prevent damage to investors caused by 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 and suspend their 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 relevant organizations

The SESC will continue working closely with Local Finance Bureaus (LFBs) from the planning stage of on-site monitoring. If a case that involves multiple LFBs occurs, the SESC will strive to enhance its guidance and coordination functions by, for instance, working out ways to collect and share information and considering appropriate monitoring methods.

The SESC will also continue collaborating closely with relevant organizations including SROs by, for instance, exchanging information in a timely manner. Sharing information and perspectives on issues as needed will contribute to the efficient monitoring of securities businesses and ensuring market fairness and transparency.

5. Dissemination of monitoring results and other initiatives

The SESC will provide FIBOs with feedback on problems and best practices found in the monitoring of securities businesses to encourage their voluntary improvement efforts, 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.*"