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Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2019–June 2020)

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 2017-2019*," released in January 2017, the SESC cited "effective risk-based monitoring of regulated entities" 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.

This document outlines the basic monitoring policy for FIBOs and sets forth the areas of focus in the monitoring activities in the 2019–2020 business year.

1. Monitoring Priorities for Securities Businesses

(1) General environment surrounding securities businesses

The global economy continues to recover gradually. However, circumstances including the development of trade issues, the outlook for the Chinese economy,

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.

the UK's exit from the EU and other situations in Europe have heightened uncertainties and pushed monetary policies toward easing once again. Under these circumstances, the rise of potential risks has been pointed out.

With respect to the Japanese financial capital markets, share prices have continued to fluctuate, although they still remain at high levels, and share trade volume has declined. Interest rates continue to remain at historically low levels.

Circumstances such as the above make it difficult for FIBOs to secure earnings under traditional business models, which rely on commission income.

Some investors' moves to pursue products with higher returns have been abused. In one case, an FIBO's sale of high-risk products to individual investors without sufficient explanations of the risks involved subsequently materialized as a problem. In another case, an unregistered business operator lured investors with the promise of high returns and caused damage.

In addition, the progress of digitalization has led to the entry of non-financial players into the financial instruments exchange business, and the use of technology such as cloud services and AI for improved business efficiency. Cyberattacks continue to be a threat to FIBOs. The importance of cyber security is rising ahead of the 2020 Olympics and Paralympics Games in Tokyo.

Furthermore, due in part to FATF's fourth mutual evaluation of Japan that will take place in autumn of 2019, Japan's financial institutions are internationally required to be achieve further sophistication in addressing Anti-Money Laundering/Counter Financing of Terrorism (AML/CFT).

(2) Approach to monitoring securities businesses

Securities businesses subject to monitoring by the SESC currently total approximately 7,200. 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.

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 that covers

economic and industrial trends and an entity's business model.

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, the SESC thoroughly conducted on-site monitoring of securities firms 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, the SESC found cases where some small- and medium-sized securities firms had made false or misleading representations on important matters upon soliciting foreign shares, as well as a case where the trade surveillance system did not fully function at a foreign securities firm mainly due to overseas outsourcing of systems functions. Furthermore, the SESC embarked on full-scale inspections in view of the rise of interest in AML/CFT following the implementation of Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism.

With respect to investment management business operators, some business operators have not been inspected for long periods. In light of such a situation, the SESC conducted on-site monitoring on business operators of major corporate groups, business operators that outsource investment management, and private placement businesses of real estate investment trust (REIT) from the perspective of control measures, including those to prevent conflicts of interest. In addition, while conducting monitoring, the SESC took into consideration developments to sophisticate asset management, with a focus on major investment management business operators.

With respect to Type II FIBOs, investment advisors/agencies, and persons who have notified that they are 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 analyses of risks associated with their products and information provided by outside sources. As a result of the on-site monitoring, the SESC found multiple cases of violations of the Financial Instruments and Exchange Act (FIEA) and problematic cases in terms of investor protection. By way of example, for sellers of loan-type funds, the SESC identified cases where sellers had made false or misleading representations about their usage of funds, and had failed to establish the control environment to comprehend the actual situation of borrowers and the usage of funds.

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.

In the current business year, the SESC will assess risks, 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, which are likely to arise amid the aforementioned trends and changes in business models. In doing so, 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.

In particular, the SESC will 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).

At the same time, particularly for regional securities firms, the SESC will conduct monitoring on the sustainability of their governance and business models (including customer-oriented business conduct), and their roles as regional operators of direct finance. The monitoring on this point will be conducted mainly off-site and from the viewpoint of contributing to the sound development of capital markets by ensuring market fairness and transparency as well as seeking investor protection.

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

In monitoring securities businesses, 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 Efforts to enhance AML/CFT measures
- ② Sufficiency of cyber security measures, implementation of system risk management that suits business model
- ③ Measures to implement customer-oriented business conduct
- ④ 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 results of monitoring in the previous business year, taking into consideration the scale of FIBOs' businesses and type of service and in accordance with the "Assessments and Strategic Priorities," the SESC will examine a FIBO if the SESC has concerns regarding its violation of relevant laws and regulations or control environments surrounding business operations, or if the actual situation of a FIBO's business operations are not fully comprehended from an information analysis conducted through off-site monitoring. The examination will be conducted with a focus on the following points.

Upon doing so, the SESC will monitor Type I FIBOs and investment management business operators that belong to major groups in view of their relationships with the overall group's strategies and operation policies.

With regard to operations related to High Frequency Trading conducted by Type I FIBOs, the SESC will look into the development of internal control environments for entrusted operations.

(1) Major securities business groups⁴

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 that is beyond mere compliance with formal rules, 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 company.

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.

⁴ Major securities business groups: Japanese securities companies with global operations

(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 products sold to Japanese financial institutions and other investors and the risks of these products.

At the same time, the SESC will monitor the status of investment banking operations, such as underwriting operations, amid the increase in the size of M&As and bond issuance, which are on the rise in recent years.

(3) Online securities firms

For online securities firms, the SESC will examine their implementation of system risk management that covers cyber security and the status of internal control environments that reflect the increase in products they offer, and their launch and expansion of face-to-face sales activities in collaboration with independent financial advisors (IFAs) and regional financial institutions. In doing so, the SESC will take into consideration the group-wide strategies and operation policies of the entire corporate group, including non-financial entities that are rapidly entering the market and their earnings.

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

Amid severe management environments arising from the outflow of customer funds through the aging of customers and inheritance, the SESC will examine whether they have inappropriately solicited customers, particularly in connection with foreign shares and high return products, or engaged in other conducts that are problematic from the viewpoint of investor protection. In addition, the SESC will examine the business operation environments of securities firms whose major shareholders or management structure changed, for example, due to participation of foreign capital or other investors and securities firms that participate in funding by companies with financial troubles.

At the same time, for regional securities firms, the SESC will conduct monitoring of governance and sustainability of their business models (including customer-oriented business conduct), and their roles as regional operators of direct finance, in close collaboration with Local Finance Bureaus (LFBs). The monitoring on this point will be mainly conducted off-site.

(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, appropriateness of stress tests, and an appropriate reflection of the results of the implemented stress tests to capital.

(6) Investment management business operators

The SESC will examine control environments for the management of conflicts of interests and outsourced investment management. Furthermore, the SESC will assess the actual situation of business operators managing real estate-related funds such as private REITs, which are in high demand from regional financial institutions and pension funds, as well as the current situation 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.

(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 examinations based on 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, 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.

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. 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 relevant organizations, including SROs, by exchanging information in a timely manner, for instance. Sharing information and perspectives on issues as needed will contribute to the efficient monitoring of securities businesses, while also effectively improving matters detected and preventing recurrences in order 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 best practices found in the monitoring of securities businesses, and sharing the monitoring results with parties related to such audits at the time of review as needed, 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*."