Tentative translation

August 2, 2022

Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2022 - June 2023)

Based on the recent environment surrounding financial instruments business operators (FIBOs), the Securities and Exchange Surveillance Commission (SESC) has compiled the priorities for its securities business monitoring[1] for Business Year 2022.[2]

Given the repeated spread of COVID-19 infections, the SESC will continue to closely monitor the situation, and take appropriate measures as necessary when conducting inspections.

1. Environment surrounding FIBOs

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In order to pass on the fruit of economic growth to households for their stable asset formation, it remains important for FIBOs, at each stage of origination, distribution and management of financial instruments, to ensure customer-oriented business conduct for acting in the best interests of their customers.

As the business environment significantly changes along with progress made in digitalization and other factors, FIBOs are developing sustainable business models, including through partnering with other securities and financial companies, promoting digitalization to meet the changing market environment and customer needs, and reviewing existing businesses.

As warnings have been issued to financial institutions to call for enhancements of cybersecurity measures amid the increasing potential risk of cyber-attacks in Japan and overseas, FIBOs are continuously required to strengthen their system risk management, including cybersecurity.

International interest has remained high in Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) measures. Based on the results of the 4th Mutual Evaluation of Japan by the Financial Action Task Force (FATF) and looking

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[1] "Securities business monitoring" in this document covers both inspection and monitoring. "Inspection" means activities based on Article 56-2 of the Financial Instruments and Exchange Act, while "monitoring" refers to activities other than inspection.

[2] Business Year 2022 is from July 2022 to June 2023

ahead to the 5th Mutual Evaluation, FIBOs are continuously required to take AML/CFT measures, including ongoing customer due diligence.

(2) Changes to regulatory frameworks for FIBOs

There have been the following changes to regulatory frameworks for FIBOs over the past business year:

(i) Revision of the firewall regulation between banking and securities businesses

Based on discussions at the Working Group on Capital Market Regulations of the Financial System Council, the Cabinet Office Order on Financial Instruments Business, etc. (hereinafter, “Cabinet Office Order”) and the Comprehensive Guidelines for Supervision of FIBOs, etc. (hereinafter, “Supervision Guidelines”) were partially revised. As a result, when banks and securities companies within the same financial groups share information of certain types of customers, such as listed companies, prior consent from and individual notice to those customers are no longer required in principle. In response to this partial deregulation, those banks and securities companies are required to sophisticate their internal control.

(ii) Review of explanations regarding solicitation for sale and switching of investment trusts

In light of requests in the report of the “Working Group on Reviewing Self-regulatory Rules from the Principle-based Approach” published by a self-regulatory organization (hereinafter, “SRO”), the Supervision Guidelines were partially revised. Through this revision, points of attention upon solicitations for the sale and switching of investment trusts and other matters were reviewed from the principle-based approach, so as to ensure that explanations are provided truly in accordance with customers’ investment objectives and levels of understanding. FIBOs are thus required to provide appropriate explanations that meet customers’ situations.

(iii) Enhancement of supervisory responses to FIBOs’ business acquisitions/mergers or suspensions

The Supervision Guidelines were partially revised to clarify the supervisory focus on ascertaining the appropriateness of FIBO’s actual business operations, where they have undergone material changes in their shareholder composition due to business acquisitions/mergers, or have suspended business operations for an extended period of time, etc. FIBOs are thus required to develop appropriate business execution systems according to the nature of their business, including when there are changes in their board composition or management policies, etc. due to acquisitions/mergers, etc.

(3) Findings through the securities business monitoring over the past business year

Through its securities business monitoring over the past business year, the SESC found that some FIBOs were transforming their business models or internal control environments in response to the changes in their business environment.

(i) Type I FIBOs

While the promotion of customer-oriented business conduct is making progress, the SESC found that a Type I FIBO with insufficient internal control environments to follow the principle of suitability was soliciting customers to switch investment trusts in a manner that was inadequate from the viewpoint of economic rationality. It also found that some Type I FIBOs were selling structured bonds, including through outsourcing to independent financial advisors and other financial institutions, in a manner that did not reflect customer needs.

While those securities companies with many online trading accounts are making some progress in their compliance with the “Guidelines to Prevent Unauthorized Access and Other Incidents in Online Trading” formulated by an SRO, the SESC found that some of them failed to sufficiently reduce the risk of unauthorized withdrawal of customer funds.

In addition, the SESC identified issues with Type I FIBOs’ compliance and governance, as in the case where a large securities company was charged for suspicion of conducting stock transactions, etc. categorized as illegal stabilizing transactions, which is a type of market manipulation.

(ii) Investment management business operators

In recent years, Japanese asset owners with massive investment assets, such as pension funds, are moving to expand their investment in alternative assets, including private equities. It is necessary for the investment management business operators to identify risks associated with alternative and other investment assets, through due diligence in accordance with product characteristics.

Nevertheless, the SESC found that an investment management business operator failed to properly manage its investment assets, including insufficient due diligence in accordance with product characteristics, with respect to discretionary investment contracts covering funds managed by an external asset management company or investment trusts established in the form of fund of funds.

In addition, the SESC identified that an investment corporation asset management business operator failed to conduct its investment management business faithfully on behalf of the investment corporation in transacting with its parent company and other interested parties, such as by giving priority to the interests of the parent company, etc. over the real estate investment corporation and making inadequate requests that undermined the independence of real estate appraisers.

(iii) Unregistered business operators

The SESC found that some business operators were, without being registered as FIBOs, intermediating conclusion of discretionary investment contracts or soliciting investment in financial instruments categorized as shares in foreign collective investment schemes.

In addition, the SESC is aware that some limited liability companies are soliciting investment in the membership rights through their employees, which could cause damage to investors. However, except for particular cases, such solicitation does not fall under the current regulatory definition of financial instruments business. The SESC thus has not been able to exercise its investigative authority to file a petition with the court for a prohibition and stay order against such solicitation. Therefore, the SESC has submitted a policy proposal to the Prime Minister and the Financial Services Agency (JFSA) Commissioner to take appropriate measures, such as expanding the scope of activity that requires registration as a financial instruments business operator.

2. Industry-wide monitoring priorities

Considering the environment surrounding FIBOs, and the JFSA's policies, such as *"The JFSA Strategic Priorities,"* the SESC will examine the following industry-wide themes in cooperation with relevant JFSA divisions:

(i) Developing internal control environments with a focus on appropriate investment solicitation based on the principle of suitability, and appropriate sales operations based on customer-oriented business conduct

For instance, with regard to the sale of products with complex risk structures, such as structured bonds, the SESC will verify whether FIBOs develop and appropriately implement internal rules concerning customer targeting and explanation, and whether FIBOs' actual sales operations are consistent with their business policies on the principle of customer-oriented business conduct.

(ii) Business model changes along with progress in digitalization, etc., and the development of internal control environments in response to such changes

For instance, the SESC will examine the impacts of business model changes, such as the expansion of non-face-to-face sales and the provision of new products and services, on FIBOs' business management, and will verify that they have appropriate internal control environments in response to these changes.

On the other hand, as for those FIBOs that remain dependent on traditional face-to-face sales, the SESC will examine the sustainability of the business model and impact of the changes in market conditions and customer needs on management, including financial aspects.

(iii) Sufficiency of cybersecurity measures, and system risk management (including those outsourced) in response to progress in digitalization

(iv) Firm establishment of internal control environments for AML/CFT

(v) Implementation of measures to improve or prevent the recurrence of matters pointed out in internal audits or SRO examinations

In addition to the above, the SESC will flexibly examine other themes in response to changes in the environment surrounding FIBOs.

3. Monitoring priorities by FIBOs' size and business type

Considering each FIBO's size and business type, as well as the environment surrounding them, the SESC will focus its examination on the following items where they could violate relevant laws and regulations or harm investor protection, such as with inadequate segregation of customer assets.

(1) Major securities business groups[3]

Given the complaints about solicitation for sales of products with complex risk structures, such as structured bonds, and the governance and risk management issues identified through the default of a U.S. investment fund, the SESC will verify that the major securities business groups have appropriate control environments

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

for governance and risk management that support global business operations, and that they are working to build sustainable business models, taking into account each group's business environment.

If necessary, the SESC will swiftly inspect relevant sales offices to examine their actual sales practices.

As for the three mega banking groups' securities companies, in addition to the above, the SESC will coordinate with relevant JFSA divisions in verifying that they have appropriate control environments for managing customer information and conflicts of interest in response to the revised firewall regulation between banking and securities businesses.

(2) Foreign securities firms

The SESC will verify that the foreign securities firms have appropriate internal control environments in response to the overseas outsourcing of back-office operations as part of their group strategies, and that they have appropriate control environments for system risk management. In light of the prolonged low interest rate environment, the SESC will also verify that they have appropriate control environments for managing sales of financial instruments to Japanese financial institutions and other investors.

(3) Online securities firms

Given the recent increasing potential risk of cyber-attacks and previous cases of unauthorized access, the SESC will verify that the online securities firms have appropriate control environments for system risk management, including cybersecurity measures.

The SESC will also verify that they have appropriate internal control environments in line with their business model changes, such as the initiatives to eliminate brokerage commissions, increases in products, and launch and expansion of face-to-face sales in collaboration with independent financial advisors.

(4) Semi-major/regional securities firms (including regional bank-affiliated securities companies)

The SESC found in its inspections that, amid the severe business environment, including the outflow of customers' assets through aging and inheritance, as well as the impact of intensifying fee competition and digitalization, some semi-major/regional securities firms were engaging in problematic practices regarding investor protection, such as inappropriate investment solicitation. Given the complaints about their sales and solicitation of structured bonds that are increasingly complex, the SESC will verify whether they are following the principle of suitability.

As for those regional bank-affiliated and other securities firms that sell structured bonds to customers introduced by registered financial institutions within the same financial groups, the SESC will verify that they have appropriate control environments for such sales.

The SESC will also verify the effectiveness of internal control environments at securities firms whose major shareholders or business management systems have changed, from the viewpoint of their business models or governance.

(5) Foreign currency margin transactions business operators

Given the recent increasing potential risk of cyber-attacks and previous cases of unauthorized access, the SESC will verify that the foreign currency margin transaction business operators have appropriate control environments for system risk management, including cybersecurity measures.

The SESC will also verify that they comply with relevant advertising regulations and have appropriate internal control environments for sales and solicitation.

In addition, in light of the sharp fluctuations in the exchange rates, the SESC will verify that they provide appropriate risk disclosure, secure sufficient capital given their stress test results, and have appropriate systems to retain and report transaction data.

(6) Investment management business operators

The SESC will conduct risk-based examinations on the investment management business operators' actual investment practices and control environments for managing investment (including those outsourced) and conflicts of interest.

(7) Investment advisors/agencies

The SESC will verify whether the investment advisors/agencies are avoiding problematic practices concerning investor protection, such as misleading advertisement and solicitation through false explanation.

(8) Type II FIBOs, and business operators, etc. engaging in specially permitted businesses for qualified institutional investors

The SESC will conduct risk-based examinations, including through analysis of information from investors, focusing on funds claiming high returns and the existence of investment projects.

As for Type II FIBOs' solicitation for loan-type funds, the SESC will verify that they appropriately disclose information about loan borrowers and screen those funds.

(9) Independent financial advisors and other securities businesses subject to monitoring

Considering that some online securities firms are launching and expanding face-to-face sales activities in cooperation with independent financial advisors, the SESC will verify that their investment solicitation is conducted appropriately, and managed sufficiently by their entrusting FIBOs.

As for other securities businesses, including registered financial institutions, credit rating agencies, securities finance companies and SROs, the SESC will conduct its risk-based monitoring in light of their business characteristics.

(10) Unregistered business operators

To prevent the expansion of damage to investors caused by unregistered business operators, the SESC will proactively exercise its investigative authority to file a petition with the court for a prohibition and stay order against their illegal conduct. The SESC will also enhance information dissemination, including the public disclosure of their and their representatives' names and illegal conduct, as well as the issuance of alerts and messages to investors regarding transactions with unregistered business operators. In addition, the SESC will proactively coordinate with relevant JFSA divisions, Local Finance Bureaus (LFBs), investigative authorities and the Consumer Affairs Agency.

In addition to the above, the SESC will examine FIBOs' response to the changes in regulatory frameworks cited in 1. (2).

4. Approach to monitoring securities businesses

(1) Inspection

Securities businesses subject to the SESC monitoring currently total approximately 8,000. These firms widely differ in size, services and products, and some of them have yet to introduce adequate basic control environments for compliance and investor protection. Therefore, it is important for the SESC, with its limited human resources and based on *"the Basic Principles of Securities Business Monitoring,"* to conduct effective, efficient monitoring of securities businesses according to their risk characteristics and promptly identify risks.

The SESC will continue to select FIBOs for inspection based on risk assessment from various viewpoints, including business types and sizes as well as business models, in cooperation with relevant JFSA divisions. Inspection will be mainly conducted in cases where it is necessary to comprehend further details, such as:

(i) a relevant law and/or regulation is breached or there is a deficiency in business operations that requires a prompt in-depth examination;

(ii) a financial instrument is offered with an unclear risk profile, necessitating an examination of its solicitation activities;

(iii) the actual business operations are not fully comprehended from information analysis based on monitoring (including where there is a long period between examinations); or

(iv) there is a possible serious problem concerning investor protection (e.g., inadequate segregation of customer assets).

In its inspections, the SESC will endeavor to conduct verification and point out problems in a practically meaningful manner, and will conduct in-depth verification by using digital forensics according to each FIBO's characteristics and issues.

Rather than merely pointing out problems and taking such actions as making recommendation for administrative disciplinary actions, the SESC will analyze the whole picture of the problems to identify their root causes, to help develop effective measures to prevent recurrence. Furthermore, if the SESC identifies the need to improve business operations before any potential issues materialize, it will describe such items as "Items to be noted" in the notification of completion of inspection, to share the awareness with the inspected FIBOs to encourage actions such as building effective internal control environments.

(2) Cooperation with relevant organizations

To make maximum use of their respective functions, the SESC and LFBs will work closely from the planning stage of monitoring and inspection, including information sharing and exchange of opinions, and conduct joint inspection as needed.

The SESC, relevant JFSA divisions and LFBs will collaborate to share information and conduct simultaneous inspection regarding the inspection of financial service intermediary businesses as well as cryptocurrency exchange service providers trading in over-the-counter cryptocurrency derivatives.

The SESC will continue close collaboration with SROs, share detected matters and awareness in a timely manner, and thereby conduct its securities business monitoring effectively and efficiently, to ensure market fairness and transparency, and investor protection.

5. Dissemination of inspection results and other initiatives

The SESC will encourage voluntary improvement efforts, including, as necessary, by providing FIBOs with feedback on problems and root causes found in its inspections, and by sharing its inspection results also with inspected FIBOs' audit-related staff and outside directors at review meetings.

The SESC will also endeavor to provide information about the SESC's perspectives in a specific and straightforward manner, including through the *"Overview of Securities Business Monitoring and Case Studies."*