

August 2, 2024

Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2024 - June 2025)

Considering the recent environment surrounding financial instruments business operators (FIBOs), the Securities and Exchange Surveillance Commission (SESC) has compiled the priorities for its securities business monitoring¹ for Business Year 2024.²

1. Environment surrounding FIBOs, etc.

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(i) Customer-oriented business conduct, etc.

The "Basic Policy Direction for Holistic Enhancement of Policy Measures to Support Households' Stable Asset Formation", formulated in March 2024, states that the government will monitor whether FIBOs and other financial businesses have developed a framework for structuring, selling, and managing financial products that serve the best interests of customers, with the aim of ensuring their customer-oriented business conduct. Regarding the reform of the asset management sector, it also states that the government will work on measures described in the "Policy Plan for Promoting Japan as a Leading Asset Management Center", such as encouraging major financial groups engaging in the asset management business to develop management and governance structures that take into account the best interests of customers. For that purpose, it continues to be important that FIBOs properly ensure customer-oriented business conduct and fulfill their expected roles sufficiently.

(ii) Sharp increase in damage caused by fraudulent investment solicitation

As investment scams using SNS, etc., are becoming more complicated and sophisticated, cases of damage caused by solicitations by suspected unregistered business operators have been increasing. The "Comprehensive Measures for Protecting People from Fraud", formulated in June 2024, states

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 In its Strategy & Policy 2023-2025 published on January 27, 2023, the SESC committed to continuing securities inspections based on a risk-based approach and responding proactively to cases where investors are harmed.

that the government will actively promote measures to eliminate unregistered business operators.

(iii) Development of sustainable business models and expansion of new financial products

As the business environment significantly changes along with progress in digitalization, population aging, and population decline, FIBOs are developing sustainable business models through such means as partnering with other securities firms and financial institutions and providing services that meet the changing market environment and customer needs. Also, in line with the development of regulatory framework for trading platforms for security tokens, a Proprietary Trading System (PTS) for security tokens has been launched.

(iv) Increasing cybersecurity risks

As cyberattacks get more sophisticated and their risks continue to increase rapidly, FIBOs are continuously required to strengthen their system risk management, including cybersecurity, under the initiative of their top management.

(v) Importance of Anti-Money Laundering/Countering the Financing of Terrorism measures

International interest in Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) measures remains high. As Japan follows up on the results of the FATF 4th Mutual Evaluation and looks ahead to the 5th Mutual Evaluation, FIBOs are continuously required to take AML/CFT measures. In this context, they are supposed to implement the “required actions” stated in the “Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism” (AML/CFT Guidelines) by the end of March 2024.

(2) Changes to regulatory frameworks for FIBOs

There have been the following changes to regulatory frameworks for FIBOs over the past few business years. In light of such changes, FIBOs are required to ensure customer-oriented business conduct and strengthen investor protection.

(i) Measures for ensuring customer-oriented business conduct

Based on discussions held by the "Customer-Oriented Business Conduct Task Force" of the Working Group on Capital Market Regulations under the Financial System Council, the Act on the Provision of and the Development of Environment for Using Financial Services and relevant Acts were amended (promulgated on November 29, 2023) to request a wide range of financial

businesses and parties related to corporate pensions, etc. to act fairly and in good faith in performing their business operations, considering the best interests of customers. Furthermore, the "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc." (Comprehensive Guidelines for Supervision) was partially amended to additionally state that supervision should be conducted while paying attention to solicitation of unreasonable short-term rollovers using the growth investment quota of NISA accounts.

(ii) Response to the progress in digitalization, etc.

Based on discussions held by the "Customer-Oriented Business Conduct Task Force" of the Working Group on Capital Market Regulations under the Financial System Council, the Financial Instruments and Exchange Act was amended (promulgated on November 29, 2023) to prohibit Type II FIBOs that provide social lending, etc. from publicly offering funds that do not guarantee the delivery of investment reports, and to apply the Act's sale and solicitation regulations to token rights based on specified joint real estate venture contracts.

(iii) Sophistication and diversification of asset management

Based on discussions held by the "Asset Management Task Force" of the Working Group on Capital Market Regulations under the Financial System Council, the Financial Instruments and Exchange Act and the Act on Investment Trusts and Investment Corporations were amended (promulgated on May 22, 2024) to introduce a voluntary registration system for outsourcees of middle and back office operations and ease the registration requirements for investment management business operators using those registered outsourcees, for the purpose of promoting new entries of investment management business operators, and to ease the registration requirements for Type 1 FIBOs that specialize in intermediary services of unlisted securities for professional investors, for the purpose of vitalizing circulation of unlisted securities.

(iv) Clarification of real estate-related fund management companies' system for preventing conflicts of interest

The Comprehensive Guidelines for Supervision was partially amended to clarify the points of attention for real estate-related fund management companies with regard to preserving appropriate records of consideration for the acquisition of real estate and establishing appropriate systems for

preventing conflict of interest.

(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 FIBOs that committed violations of laws or regulations or conducted inappropriate business operations.

(i) Type I FIBOs, registered financial institutions, financial instruments intermediary service providers

With regard to customer-oriented business conduct, the SESC found that some major securities firms and regional securities firms conducted inappropriate business operations that conflicted with the principle of suitability, such as failures to provide sufficient explanations in light of the attributes of individual customers.

The SESC also found that securities firms, etc. belonging to one of the three mega-bank groups exchanged non-public client information although the clients had prohibited information sharing with other group firms, that those firms managed their clients' corporate information inappropriately, and that a registered financial institution belonging to the same group negotiated with and solicited customers to designate its affiliated securities firms as underwriter.

The SESC found that an online securities firm accepted purchase orders for newly listed shares for which it served as the lead-managing underwriter, via several financial instruments intermediary service providers, while knowing that such orders would result in the formation of manipulative quotations not reflecting actual market status.

The SESC also found that a foreign currency margin transactions business operator conducted stress testing using falsified data as instructed by its president in order to avoid deterioration of test results.

(ii) Investment management business operators

The SESC found that an investment management business operator that manages a real estate investment corporation had an insufficient system for managing risks of conflicts of interest, such as not preserving records on how it validated the yield it adopted when assessing real estate to be acquired from an interested party.

In addition, the SESC found that an investment management business operator that manages investments based on a discretionary investment contract had a deficient decision-making process, such as determining an

investment plan at its internal meeting before completing due diligence.

(iii) Investment advisors/agencies

The SESC found that an investment advisor/agency violated laws and regulations, such as making false representations regarding expected profits on its website that significantly conflict with the fact, and including false statements in its statutory books and documents to make the representations appear true.

The SESC also found that an investment advisor/agency failed to work faithfully on behalf of its customers in providing its investment advisory business, such as giving trading advice to specific customers prior to general customers.

In addition, the SESC found violations of laws and regulations by an investment advisor/agency, including soliciting investment advisory contracts through providing false information on its advisor and advisory performance or making misleading representations regarding its credibility and the number of its customers.

(iv) Type II FIBOs

The SESC found that an investment-type crowd funding operator received money deposited by its customers without satisfying the requirements for conducting the act of management of specified securities, etc., such as appropriate segregation of customer assets and its own assets.

(v) Unregistered business operators

The SESC found that a business operator handled a public offering or private placement of interests in collective investment schemes under foreign laws and regulations, without registration as an FIBO.

2. Industry-wide monitoring priorities

Considering the environment surrounding FIBOs, and the Japan Financial Services Agency's (JFSA's) policies such as "*The JFSA Strategic Priorities*," the SESC will examine the following industry-wide items in cooperation with relevant JFSA divisions:

- (i) 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

In light of diversification of financial instruments, with regard to the sale of

complex or highly-risky products, for instance, the SESC will examine whether FIBOs develop and appropriately implement internal rules concerning customer targeting and explanation, whether they appropriately monitor compliance with such internal rules, whether they do not solicit unreasonable short-term rollovers, and whether their actual sales operations are consistent with their policies on the principle of customer-oriented business conduct. In addition, the SESC will examine FIBOs' sales and solicitation activities in their bank-securities collaborative business and their internal control environments including customer information management.

- (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 FIBOs' business model changes, such as the expansion of non-face-to-face sales and the provision of new products and services, on their business management, and will verify that they have appropriate internal control environments in response to those changes.

On the other hand, as for those FIBOs whose business models remain dependent on traditional face-to-face sales, the SESC will examine the sustainability of such business models and the financial and other business impacts of the changing market conditions and customer needs.

- (iii) Sufficiency of cybersecurity measures (including countermeasures against unauthorized access in online trading), and system risk management (including management of system development and operation and management of trustees) in response to progress in digitalization
- (iv) Firm establishment of internal control environments relating to AML/CFT measures

The SESC will verify the implementation of the “required actions” stated in the AML/CFT Guidelines.

- (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 items in accordance with 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 conduct examination with a focus on the following items, regarding which FIBOs could violate relevant laws and regulations or harm investor protection such as with inadequate segregation of customer assets.

(1) Major securities business groups³

Considering the business environments surrounding each major securities business group, the SESC will continue to verify that they have appropriate control environments for governance and risk management that support global business operations, and that they are working to build sustainable business models.

Given that deficiencies have been found in their business operation, including trade screening, the SESC will verify that they have appropriate internal control environments, including those for detecting and preventing market misconduct.

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

(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.

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 sophistication of cyberattacks and sharp increase in cyber risks, the SESC will verify that the online securities firms have appropriate control environments for system risk management, including cybersecurity measures.

Additionally, the SESC will verify that they have appropriate control environments for managing outsourcees in response to the expansion of face-to-face sales activities using financial instruments intermediary service providers, and that they have appropriate business operation environments in line with their business model changes such as the provision of new products and services.

The SESC will also verify that they have appropriate internal control

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

environments, including effective trade management that can deal with increases in newly opened accounts and transaction volume associated with the commencement of the new NISA program.

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

The SESC will verify that the semi-major/regional securities firms are developing or considering sustainable business models amid the severe business environment due to the outflow of customers' assets through aging and inheritance, intensifying fee competition, and digitalization. The SESC will also examine whether they are following the principle of suitability.

The SESC will also verify the effectiveness of internal control environments at those 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 sophistication of cyberattacks and sharp increase in cyber risks, 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 examine compliance with relevant advertising regulations, internal control environments for sales and solicitation, and the OTC FX business operators' settlement risk management, including the implementation of stress testing.

(6) Investment management business operators

The SESC will examine the investment management business operators' actual investment practices, and their control environments for managing investment (including those outsourced) or conflicts of interest (including whether the validity of transactions can be checked ex post facto).

(7) Investment advisors/agencies

The SESC will examine whether the investment advisors/agencies are free from problematic practices in terms of investor protection, such as solicitation and advertisement through false explanation, or violation of the duty of loyalty.

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

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

The SESC will focus on funds claiming high returns and the existence of investment projects, including through analysis of information from investors.

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

(9) Registered financial institutions

The SESC will examine whether the registered financial institutions have appropriate internal control environments, such as for ensuring the appropriateness of investment solicitation and following the principle of suitability.

(10) Financial instruments intermediary service providers and other securities businesses subject to monitoring

Considering that some online securities firms are 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 credit rating agencies, securities finance companies, and SROs, the SESC will conduct its monitoring in light of their business characteristics.

(11) Unregistered business operators

To prevent the spread of investor damage through eliminating 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 the unregistered business operators 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 further strengthen collaboration 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 the securities business monitoring

(1) Inspection

Business operators subject to the SESC's securities business monitoring currently total approximately 8,500. They widely differ in size, services, and products, and some 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 its securities business monitoring effectively and efficiently according to FIBOs' risk characteristics and promptly identify risks.

The SESC will continue to take a risk-based approach in selecting FIBOs for inspection, through risk identification and assessment in collaboration with relevant JFSA divisions, and will continue to be proactive in ascertaining their actual situations through inspections, with a focus on the following situations. Also, the SESC will conduct inspections in a flexible manner, including by narrowing down items for verification as necessary:

- (i) where there are specific legal violations or doubts about business operations, which necessitates prompt in-depth verification;
- (ii) where an FIBO's actual business operations cannot be fully comprehended through monitoring (including FIBOs for which inspection has never been conducted or has not been conducted for a long period of time, and FIBOs whose business models and business operations were altered upon a change in the shareholder composition as a result of merger, etc.); or
- (iii) where it is necessary to ascertain actual conditions regarding risks of financial instruments dealt in and the appropriateness of segregation of customer assets.

In its inspections, the SESC will endeavor to examine and point out problems in a practically meaningful manner, and examine them in depth by using digital

forensics according to each FIBO's characteristics and issues.

Rather than merely pointing out problems and taking such actions as making a 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

The SESC and LFBs will work closely from the planning stage of inspection, including information sharing and exchange of opinions, and the SESC will exercise its coordination function to support initiatives of LFBs. In addition, joint inspection between the SESC and LFBs or among LFBs will be conducted as needed, and LFBs will mutually offer support for inspection flexibly.

The SESC, relevant JFSA divisions, and LFBs will collaborate to share information and conduct simultaneous inspections 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 and will endeavor to further expand and deepen the collaboration. The SESC will share matters detected through inspection and supervision, etc. and its awareness of problems in a timely and interactive 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

As necessary, the SESC will encourage voluntary improvement efforts by inspected FIBOs by providing feedback in collaboration with relevant JFSA divisions on problems and root causes found, and by sharing inspection results also with their audit-related staff members and outside directors at review meetings.

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