

## 1 Overview of activities in Fiscal Year 2017

Various changes took place in FY 2017 (April 2017 – March 2018) in the domestic and global economic environment affecting Japan's securities markets. Domestically, negative interest rates remained in place. Globally, strong economic recoveries resulted in moves toward ending the loose monetary policies. Listed companies in Japan, meanwhile, have been booking record levels of earnings and actively expanding their business as evidenced by the increasing number of M&A both in Japan and abroad. However, despite the strength of the world economy, uncertainties continue to grow, including via heightening of geopolitical risks such as the situation with North Korea.

Given such circumstances, in FY 2017 the Securities and Exchange Surveillance Commission (SESC) conducted market surveillance with a forward-looking perspective, focusing on risk factors and changes in the environment in both Japan and abroad through analysis under a macro-economic approach. In performing its monitoring and investigation duties, the SESC not only made recommendations for administrative actions against violations of laws and regulations but also looked closely into the root causes to prevent recurrences.

## 2 Recommendation for administrative monetary penalties and criminal charge filings against market misconduct

### (1) Number of Recommendation for administrative monetary penalties and criminal charge filings against market misconduct

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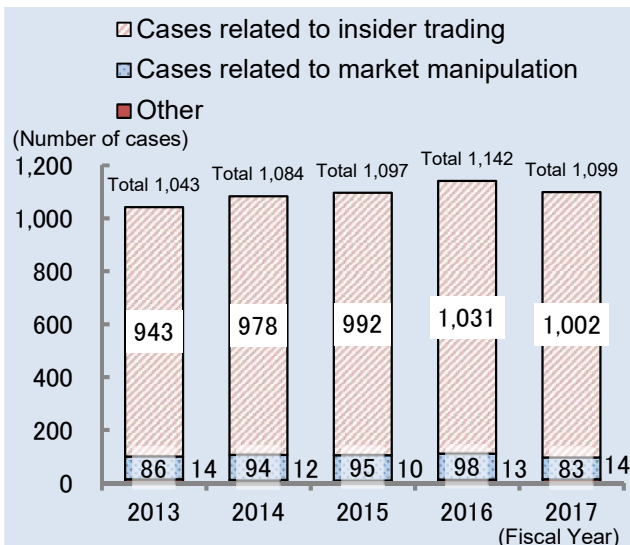
In FY2017 there were 26 cases of market misconduct (21 insider trading and five market manipulation cases) in which the SESC made recommendations of administrative monetary penalty payment order and four cases in which the SESC filed criminal charges.

### (2) Market oversight leading to recommendations and criminal charges

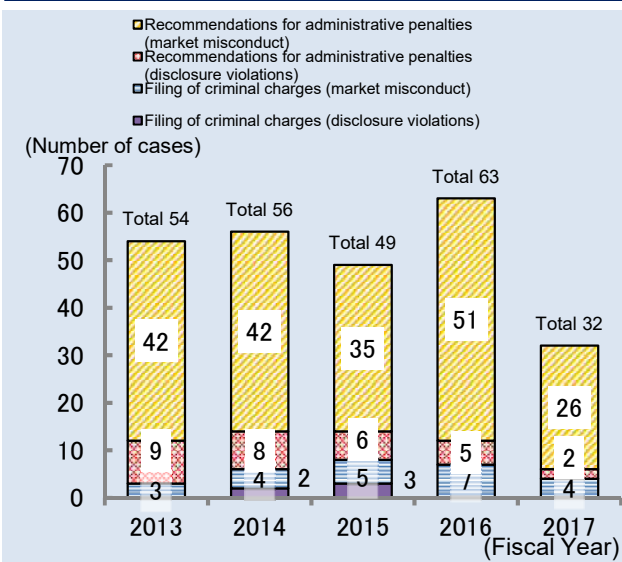
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The total number of cases examined for detecting market misconducts was 1,099 in FY 2017, which marked the fifth consecutive year of over 1,000 examinations.

## Market Oversight Examinations



## Recommendations and Criminal Charge filings



### (3) Trends in market misconduct

With regard to insider trading, those cases involving tender offers and business alliances as material fact continued to constitute a substantial portion of the cases. Underlying such development is the growing needs for corporate reorganization and effective use of precious corporate resources to keep pace with environmental changes where the economy is becoming increasingly borderless and global. In addition, the SESC made its first

recommendations for two categories of material facts, respectively; one involved the occurrence of the cause for delisting (the company would be insolvent for two consecutive years) and the other, disposal of fixed assets (the company sold the land on which its head office was established for debt reduction), both reflecting severe business conditions. In the course of investigations of insider trading, the SESC found issues regarding management of insider information at listed companies. In one case, for example, the material information was not promptly and adequately registered with the section in charge, which led to the absence of proper management of stock transactions.

The scheme of market manipulation became increasingly complicated and sophisticated. For example, in one case, a wrongdoer used multiple brokerage accounts for the purpose of avoiding detection of illegal transactions, while in another, a wrongdoer used “at-market order at closing” for layering or spoofing<sup>1</sup>. There also was a case where a wrongdoer used the combination of spoofing orders and wash trades to induce algorithmic trading orders from other investors.

Further, the SESC recognized a case where an institutional investor placed a

<sup>1</sup> An example of layering or spoofing would be issuing a bulk buy order with low priority in the price range shown on the exchange information screen without intending to execute the transaction.

large amount of sell orders toward the market closing to suppress the price.

#### **(4) Policy going forward**

Going forward, the SESC will continue to improve its market-monitoring systems and review the methods of investigation and inspection in order to keep pace with the changing environment surrounding the market and ensure flexible implementation of investigation and inspection.

The SESC will also publish a case book of administrative monetary penalties, which will provide information on trends and overview of recommendations and identify possible points for improvement regarding the control system to prevent insider trading, in an effort to prevent both recurrences and occurrences of market misconduct.

### **3 Detection and prevention of disclosure violations**

#### **(1) Recommendation against disclosure violations**

The SESC made recommendations regarding two cases of disclosure violations in FY 2017.

#### **(2) Trends in disclosure violations**

The cases in which the SESC found disclosure-related problems involved ineffective internal controls regarding management of subsidiaries and excessive emphasis on sales coupled with

disregard for control departments, which suggested underlying governance malfunctions and inadequate awareness of compliance at the companies concerned.

Even among cases where there were no clear indications of disclosure violations, there were cases in which internal review of their own issues were inadequate, raising concerns of potential risks in internal control.

#### **(3) Policy going forward**

The SESC will continue to gather information and conduct analysis with a focus on the potential risk of disclosure violations, and aim to deepen its analysis.

Furthermore, the SESC will hold dialogue with the management of listed companies that have committed disclosure violations on the causes of the violation and share awareness so as to help them build internal systems for proper information disclosure. The SESC will also proactively publish and disseminate details of actual disclosure violations detected in inspections of disclosure statements. Such efforts will collectively prove effective in preventing both recurrences and occurrences of disclosure violations.

#### 4 Seamless on-site/off-site monitoring of FIBOs<sup>2</sup>

##### (1) Principle approach to monitoring securities business

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Since the 2016 business year<sup>3</sup>, the SESC has been conducting risk assessments of all FIBOs through off-site monitoring involving analyses of the environment, covering economic and industrial developments, as well as the FIBOs' business models, which leads to risk-based selection of FIBOs for on-site monitoring (on-site inspections).

In carrying out on-site monitoring, the SESC aims to not only point out legal problems and make recommendations for administrative disciplinary actions, but also analyze the whole picture to identify root causes of the problems so that the FIBOs can design effective measures to prevent recurrences.

In cases where the needs for improvement of business management or other aspects are detected, even in the absence of serious problems, the SESC will identify them as "issues requiring attention" in its final report to the FIBOs

subject to the monitoring so as to share the awareness and encourage the entity to establish an effective internal control system or address issues.

##### (2) Recommendations for administrative disciplinary actions against FIBOs

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In FY2017 ten recommendations for administrative disciplinary actions against FIBOs were made.

These cases involved FIBOs that conducted highly problematic business, lacking awareness for legal compliance and investor protection. In one case, a branch manager of a securities firm illegally compensated multiple customers for losses incurred in securities transactions. In another case, a Type II Financial Instruments Business Operator posted an advertisement on the website that was significantly contradictory to facts. There was also a case where an investment advisor/agent provided investment advice with the view to use customer transactions for their own benefit.

##### (3) Policy going forward

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While operators subject to SESC's monitoring total approximately 7,000 on a gross basis, their size, service and products are diverse. Furthermore, there are operators that are still short of fundamental awareness and controls for compliance and investor protection. The SESC will take such circumstances into

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<sup>2</sup> In this document, "FIBOs" stands for any business operators that are subject to securities monitoring, including Financial Instruments Business Operators, registered financial institutions, financial instruments intermediary service providers, Qualified Institutional Investor Business Operators ("QII Business Operators"), credit rating agencies, and so on.

<sup>3</sup> The 2016 business year refers to the period from July 1, 2016 to June 30, 2017.

consideration and endeavor to accurately identify where risks exist through effective and efficient monitoring.

In particular, the SESC will continue to conduct on-site monitoring in a flexible manner in cases where the needs for deeper examinations are identified at an early stage and further understanding of details are critical with regard to possible violations of relevant laws and regulations or deficiencies in internal controls.

## 5 New challenges for the SESC: Efforts to enhance RegTech

### (1) Information gathering on developments in financial technologies and authorities' use of information technology in Japan and abroad

Advancements in IT and the convergence of finance and IT (FinTech) in recent years have brought dramatic changes to the transactions subject to the SESC's monitoring, which may lead to the emergence of new risk factors. Aware of the situation, the SESC has set a "more active use of IT in the market surveillance system (RegTech)" as one of its focus policy areas and continued to gather information on developments in financial technologies in Japan and abroad as well as how IT is used by regulatory authorities and other parties, both domestically and abroad.

## (2) Policy going forward

Based on the results of information gathering, the SESC will press ahead with preparations to introduce new market surveillance systems that involve utilization of advanced technologies as the means of responding not only to new technologies in financial markets, such as block chain and AI (artificial intelligence), but also to changes in business processes and business models resulting from the adoption of FinTech, thereby ensuring that market surveillance continues to be effective.

Furthermore, considering that new IT advances, such as the entry by listed companies and FIBOs into the cryptocurrency business and fund procurement via ICOs <sup>4</sup> (Initial Coin Offerings), could affect markets in various ways, the SESC will also be keeping a close eye on them.

## 6 Cooperation with relevant authorities and accountability

### (1) Cooperation with relevant authorities

The SESC is working with self-regulatory organizations (e.g., JPX-R(Japan Exchange Regulation) and financial products dealers

<sup>4</sup> Generally regarded as a catch-all term for the electronic issuance by companies etc. of tokens in order to procure fiat currency or virtual currency from the general public.

associations, hereinafter “SROs”) on a daily basis including in surveillance of trades and reviews on the appropriateness of their members’ operations. The SESC further strengthened cooperative relationship with the SROs through periodic dialogues where the parties mutually shared concerns on a timely basis by actively discussing various issues and challenges relating to market surveillance. In FY 2017, the SESC had 16 of such periodic dialogues with SROs, and also met with FIBOs and relevant authorities to exchange views.

In terms of communication with overseas regulators, the SESC participates in multilateral discussions on a variety of topics at IOSCO<sup>5</sup> and actively engages in exchange of views on a bilateral basis. In addition, the SESC made a total of 20 requests to overseas regulators in relation to investigations into market misconduct using cross-border transactions based on the IOSCO MMoU (Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information) in FY 2017.

## **(2) Effective dissemination of information**

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The SESC strives to enhance its external communication by making the information more specific and easier to

understand. For each case, the SESC endeavors to provide a clear illustration of the overview, issues identified and significance at various occasions including the publication of individual cases at the time of recommendation, publication of major findings in casebooks on monetary penalties and FIBO monitoring results, as well as contribution of articles and lectures. In FY2017, the SESC spoke at a total of 17 seminars and other occasions to market participants, certified public accountants, attorneys, etc.

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<sup>5</sup> International Organization of Securities Commissions