

## **Annual Supervisory Policy for Financial Instruments Business Operators, etc. for Program Year 2011**

The Financial Services Agency (FSA) publishes its Annual Supervisory Policy for Financial Instruments Business Operators, etc. for each program year so as to clarify its supervisory priorities. This is prescribed in the “Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.,” which shows basic approaches for the supervisory process aimed at financial instruments business operators, etc.

In this Program Year, in accordance with the “Basic Concept on Future Supervision of Financial Institutions” as shown below, the FSA will place priority on the areas of 1) appropriate functioning of market intermediation, 2) promotion of high quality risk management, and 3) improving customer protection and convenience for users, and will supervise Financial Instruments Business Operators, etc. while striving to have frank and deep discussions with them.

It should be noted that this supervisory policy was drawn up in light of the circumstances that surrounded financial institutions as of August 2011, and may be subject to review as necessary.

### 1. Environment Surrounding Financial and Capital Markets, and Basic Concepts on Future Supervision of Financial Institutions

#### (1) Environment Surrounding Financial and Capital Markets

Due to the impacts of the Great East Japan Earthquake, the Japanese economy remains in a difficult situation. However, reflecting supply chain reconstruction, the Japanese economy is expected to continue to pick up. Even in this situation, there are downside risks that could stem from constraints of electric power supply, the consequences of the nuclear accident, further slowing down of overseas economies, and fluctuations in exchange rates and stock prices.

Even when Japan is in such a difficult situation, the world economy has been moving on instead of halting, and special attention should be paid to movements in foreign economic conditions and financial and capital markets. In doing so, amidst today’s advancing globalization, it is important to enhance the resilience of the economic and financial system, to minimize impacts on our country in the event of any crisis arising from emerging global economic risks.

Looking at conditions in each country, for example at emerging economies, their economic growth supported by domestic demands is contributing to the creation of investment opportunities and new consumer markets in developed countries. On the other hand, attention should be paid to risks of real estate prices and inflation. The U.S. economy faces downside risk due to its continued high unemployment rate, falling housing prices, etc. In Europe, financial system concerns remain, amid concerns over fiscal conditions in some countries.

Under these conditions, it has become even more important that financial instruments business operators practice legal compliance thoroughly and also properly perform their market intermediary functions as market participants, thereby enhancing investor confidence in Japan's markets and leading to fair price formation for financial instruments. For financial instruments business operators to play this role, they must maintain their financial resilience by practicing risk management, etc.

## (2) Approach Taken by Supervisory Authority

Amid these circumstances, the FSA will continue to place "Better Regulation" as the basis (engaging in frank and deep discussions with financial institutions, disseminating information to the outside, sharing and linking information on the economic and financial situations in Japan and overseas, and improving the transparency and predictability of regulatory actions) and striving to have it become further embedded and deepened.

In particular, in appropriately performing market intermediary functions, and accurately managing various risks, customer protections, etc., financial institutions are strongly expected to be aware of each long-term managerial issue. They are also expected to conduct positive managerial improvements, and make appropriate, fast and responsible business judgments under the appropriate leadership of management personnel. To this end, the FSA will continue to take the following approaches as the supervisory authority.

### 1) Financial Administration with a High Risk Sensitivity

In order to accurately respond to currently conceivable risks, the FSA will gain a deeper understanding of the macro economy and financial and capital markets, and deepen its understanding of how these affect the soundness of financial institutions, so as to identify and understand the risks which accumulate in each financial institution and in the financial system with a forward-looking perspective. The FSA will also enhance integration of on-site and off-site monitoring to detect risks at an early stage.

It is also important to check whether major risks are fully assumed in the financial institution's business continuity plan, in order to maintain and ensure financial functions even if an unexpected event occurs. This should include the consideration of the experience of the recent Great East Japan Earthquake. Moreover, IT systems are at the core of financial services, and the occurrence of a problem can greatly affect people's lives and the economy. With this in mind, it is important that each financial institution and the FSA examine the design of its risk management system in case a failure occurs. As the supervisory authority, the FSA should sort and analyze these inspection results.

### 2) Financial Administration from a Citizen's and User's Point of View

The FSA will strive so as to further improve customer protection and convenience for users, by bearing in mind a citizen's and user's point of view. The FSA will especially check whether in response to the Great East Japan Earthquake, each financial instruments business operator is handling various procedures from the customer's standpoint in a flexible and attentive manner.

These include providing disaster victims with fast payment of proceeds from the sale of deposited assets (and cancellation of contract).

### 3) Supervisory Response with a Forward-looking Perspective

In addition to policies from a short-term perspective, the FSA will strive to implement medium and long-term initiatives with an eye on the future. To this end, the FSA comprehends the development of international discussions and environmental changes, considering structural issues faced by Japanese financial institutions (enhancing profitability of their main business, etc.).

### 4) Supervisory Response which Contributes to Financial Institutions Autonomously Improving Management and Making Better Business Judgments.

The FSA will help financial institutions autonomously improve management and make better business judgments via frank and deep discussions with and the distribution of information to financial institutions. Above all, through exchanges of opinions with the financial institutions and other methods, the FSA to introduce to other financial institutions the innovative initiatives of each financial institution regarding market intermediation functions, risk management, enhanced customer protection and user convenience, etc. It thereby works to enhance the quality of the entire financial industry.

In performing supervision, in addition to these approaches, the FSA will also bear the following points in mind.

- In addition to encouraging closer cooperation with the Securities and Exchange Surveillance Commission (SESC) and other affiliated divisions as well as with self-regulatory organizations (SROs) and the Bank of Japan (BOJ), the FSA will also strive to cooperate with overseas authorities via supervisory colleges, and positively contribute to organizations which set international standards.
- The necessity of collecting reports and submitted documents will be periodically reviewed once per year, as part of considerations for reducing the burdens on financial institutions.
- Through the fostering and securing of staff members with expertise and improving training sessions of specialized human resources, the FSA will redouble efforts for human resource development.

## 2. Appropriate Performance of Market Intermediation Functions

In the New Growth Strategy decided in the Cabinet in June 2010 and “The Action Plan for the New Growth Strategy” announced by the FSA in December 2010, financial institutions are expected to support the real economy and enterprises. The financial sector is also expected to lead the economy as a growing industry itself.

When investors and fundraisers access the market, financial instruments business operators play a public role as market intermediaries, and it is important that those financial instruments business operators, through appropriately performing a market

intermediary function, enhance investor confidence in Japan's markets and encourage fair price formation of financial instruments.

Considering the above, in this program year, the FSA will supervise the performance of market intermediary functions by financial instruments business operators, from the following viewpoints.

- 1) Financial instruments business operators are required to develop internal controls systems in order to perform an appropriate market intermediary function as mentioned above. Each company's system is examined from such a viewpoint. In addition, taking into account the recent situations concerning new listings in the markets, the FSA will examine whether their screening system for IPO underwriting is functioning appropriately.
- 2) Customer information forms the basis of financial instruments transactions and the intermediation thereof, and so it also needs to be managed strictly from the viewpoint of protecting personal information. Furthermore, it is important to strictly manage corporate information, such as that on public offerings by listed companies, in order to enhance confidence in market transparency and fairness. From these viewpoints, the FSA will examine whether management is playing a leading role to make efforts for the maintenance of internal control systems for information security, and for the enhancement of professional ethics to prevent inappropriate conduct by staff (such as information leaks and insider trading).
- 3) In order to ensure that antisocial forces such as organized crime group are thoroughly excluded from securities transactions, the FSA will urge the early construction of the antisocial forces database, which is being studied by the Japan Securities Dealers Association in cooperation with the National Police Agency. The FSA will also encourage stronger efforts in each securities company to exclude antisocial forces.

### 3. Promotion of High Quality Risk Management

The earning environment of financial instruments business operators is generally harsh with few large underwriting deals, sluggish current market conditions, etc, though investment trust has a steady inflow of funds. Under these conditions, it is increasingly important for financial instruments business operators to thoroughly perform high quality risk management. The FSA will encourage self-motivated efforts by each financial instruments business operator, especially regarding the following points.

#### (1) Encouraging Integrated Risk Management of the self-motivated Securities Company Group

- 1) Considering that some securities companies have suffered large losses because they could not recover the money they advanced for customer transactions, the FSA will require thorough, higher quality risk management. Also, in order to maintain soundness of businesses, the FSA will continue to properly operate the early warning system. The FSA also comprehends an overview of business

models and recent business conditions, and performs cross-industry and time-series analyses.

- 2) Consolidated supervision and regulation of securities company groups were introduced in April 2011. Based on these frameworks, the FSA examines entire groups' integrated risk management systems, while it prioritizes the timely and accurate understanding of the business status of entire groups regarding special financial instruments business operators and designated parent companies .

Especially for securities company groups, which are internationally active and have large and complex operations, considering their great potential impacts on the financial system and entire economy, the FSA will perform even more detailed monitoring of their financial soundness and risk management in a forward looking manner. To this end, integrated on-site and off-site monitoring would be performed and strengthened in close cooperation with inspection divisions. Based on international discussions, such as in the Financial Stability Board (FSB), the FSA works for the creation of Recovery and Resolution Plans (RRPs) of financial institutions which are internationally active and conduct large and complex business.

For securities companies under large financial groups composed of major banks, the FSA also examines especially their risk management systems built on their business models, risks and corporate cultures, which differ from deposit-taking financial institutions.

The FSA will also continue policy responses based on analysis on whether the entire financial system is expected to develop sustainably and stably from the viewpoint of macro prudence, in close cooperation with the Bank of Japan. This analysis looks into the impacts on the financial system due to domestic economic trends affected by disasters etc., real economies overseas, and financial market trends.

#### (2) Initiative for Various Funds

In order to take necessary actions in a forward looking manner in anticipation of the future emergence of risks, the FSA, by continues to conduct fund monitoring surveys as part of its work to comprehend the situation of solicitation and operation of various funds, including hedge funds.

#### 4. Improving Customer Protection and Convenience for Users

Improving customer protection and convenience for users in financial institutions helps to enhance investor confidence in Japan's markets, and contributes to the development of sound markets in Japan. It is important for financial institutions to raise their competitiveness by providing original and ingenious financial instruments/services that accurately reflect customers' needs. This effort should be backed by a sense of security and confidence that could be gained by thorough protection of customers' interest. To this end, the management of a financial institution should fully provide his/her leadership. In particular, compliance in terms of customer protection should not mean a simple compliance with laws and

regulations. Rather, as trusted financial institutions with a highly public nature, it is important that they are aware of the levels expected by customers, and meet those expectations. To this end, the financial institution must first accurately study and decide whether financial instruments, etc. are suitable for sale and solicitation, considering their customers' profile (knowledge, experience, asset situation, goals, etc.), then develop their financial instruments, etc. Furthermore, when selling and soliciting financial instruments etc., appropriate explanations which suit the customer's profile is essential. Financial institutions have to also be aware that customer consultations and complaints after sale are opportunities to discover potential customer needs, and should respond to them appropriately and actively.

Considering the above, in this program year the FSA examines particularly the following initiatives for accordance with guidelines for supervision, aiming to have improved customer protection and better convenience for users in financial instruments business operators.

In doing so, the FSA will respect the self-motivated efforts of each financial instruments business operator, and proceed with supervision that places importance on incentives. In its supervision of financial instruments business operators, the FSA will also pay attention to (1) under what kinds of management policies, what kinds of financial products and services financial instruments business operators are providing to customers with what kinds of profiles, (2) whether there are warped incentives that may arise because financial instruments business operators are pursuing short-term profits or because they have conflicts of interest, (3) whether a system is developed to internally check (including by management) whether management policies are thoroughly implemented in a front office.

Furthermore, the FSA will cooperate with the police authorities and with the Consumer Affairs Agency as required.

#### (1) System Solicitation and Explanation to Customers

In the sale and solicitation of financial instruments, it is not sufficient that financial instruments business operators simply comply with the laws and self-regulations. It is also important that they strive to provide easily understood explanations from the customer viewpoint, so customers can understand product qualities and risks characteristics.

Regarding methods of sale and solicitation by financial instruments business operators, while taking into account information which the FSA receives from investors, the FSA will conduct detailed interviews with operators periodically and as needed, in order to understand the situation of sale, solicitation and the customer follow-up system of each operator, and urges businesses to make improvements.

Based on this viewpoint, the FSA will urge financial instruments business operators to thoroughly implement sales in line with the customer's viewpoint in order to build long term relationships with customer.

- 1) With regards to sales of products that carry risks, such as investment trusts, structured bonds and derivatives (including currency derivative products), the FSA examines whether the system of solicitation and explanation considers each customer's standpoint, including compliance with the regulation of unsolicited offers. In particular, the FSA looks into whether (i) appropriate and

flexible explanations that are suitable and easily understood by each customer are being provided, taking into account the situation of the customer's knowledge, experience, assets, purpose of investment, etc. in order to enable the customer to accurately judge the locations and characteristics of risks; (ii) check sheets are produced and collected from customers where needed to confirm that the customer understood the explanation, (iii) warning documents are provided, (iv) the salary and bonus systems of sales staff and managers are not biased towards performance with excessive links to gaining short term profits, (v) the sales system and product composition are not focused on gaining fee earnings.

- 2) The FSA will especially focus on examining whether (i) suitable explanations are being provided corresponding to each product characteristic and risk characteristic, when selling investment trusts such as funds targeting foreign stocks and bonds, currency selection type funds, and monthly distribution type funds, (ii) suitable explanations are being provided at the time of sales and cancellations of investment trusts, regarding important items which affect customer investment decisions, such as profits and losses, commissions and investment trust fees and other costs of sales and cancellations, (iii) the financial instruments business operator is working from the customer's viewpoint, for example creating and providing to customers documents with easily understood descriptions of characteristics of risks, fees and distributions (e.g. mandatory prospectus), etc.

## (2) Customer Management After Product Sale

The relationship between a financial institution and an investor does not end at the time when the product is sold. Intimate care after the product sale is also essential for building trusting relationships with investors.

It is especially important to provide timely, accurate and easily understood information to customers on market trends and changes in issuer's credit strength that affect price changes in investment products, in order to deepen investors' understanding, and to provide detailed support for investment decisions. As part of this, the investment decision-making ability of elderly customers can change in a short time, and it is essential to provide them with especially careful follow-up, such as diligently providing advice from the customer's standpoint.

From this viewpoint, the FSA will encourage appropriate after care from the customer's viewpoint.

## (3) Complaint and Consultation Handling System

For cases in which trouble arises between the financial instruments business operator and an investor concerning a financial instrument transaction, it is important that each operator handles it sincerely, and strives to enhance the investor's feeling of consent.

Especially for mediation procedures in the financial Alternative Dispute Resolution (ADR) system, financial instruments business operators are required to act sincerely for fast dispute resolution, such as by actively disclosing required information.

From this viewpoint, the FSA examines the complaint and consultation handling system in each operator, and encourages their handling from the investor's viewpoint.

#### (4) Business Continuity

- 1) For financial instruments business operators which operate on customers' assets deposited with them, when there are any indications of discontinuance of business due to deteriorating financial conditions, the FSA works with careful attention for the protection of customers' assets. For financial instruments business operators that do not operate with customers' assets deposited with them, the FSA will also deal with any information gained concerning the continuity of operations in an appropriate manner from the standpoint of client protection.
- 2) Computer systems of financial institutions are at the core of their settlement systems. These have a strong public aspect as social infrastructure. If a failure occurs, this has large impacts on user convenience and the society, and unavoidably leads to lost credibility as a financial institution. Considering the important roles in the market played by financial instruments business operators, the FSA encourages each operator to conduct voluntary checks under active leadership by management, regarding awareness of IT system risks, ensuring IT system sufficiency in response to changes in the external environment, business strategy on IT system investments (including human resource allocation and human resource training), risk management when failure occurs, and ensuring an appropriate audit system, etc. The FSA also focuses on examining these matters. The FSA also examines whether management is appropriately aware of relevant risks, and whether it manages projects appropriately when operators update or integrate IT systems, etc.
- 3) Considering the experience of the recent Great East Japan Earthquake, the FSA comprehend the status of financial institutions' verification of whether their business continuity plans functioned effectively until now, whether they sufficiently assume major risks, such as earthquakes, other natural disasters, pandemic influenza and large electricity blackouts, whether their contingency plan is sufficient, etc.

Electricity supply capacity has decreased since the earthquake, and each financial institution is now implementing electricity conservation policies this summer in each area in Japan, especially in areas under the jurisdiction of Tohoku Electric Power Company, Tokyo Electric Power Company and Kansai Electric Power Company. As current policies, the FSA carefully watches these electricity conservation policies, and examines whether there are impacts on the business continuity of important locations, such as IT system centers.

#### (5) Compliance with Regulations on Foreign Currency Margin Transactions

Regarding foreign currency margin transactions, the FSA examines the status of FX businesses' responses to enhanced margin regulations enforced since this August. The FSA also continues to examine each company's advertisement, and the

solicitation and explanation systems of businesses which provide low spread transactions.

(6) Self-regulation in Type II Financial Instruments Business

This June, the Type II Financial Instruments Firms Association was approved as an authorized financial instruments firms association. The FSA encourages stronger initiatives for investor protection concerning type II financial instruments business, including encouraging the association to quickly perform self-regulatory functions, such as creating self-regulatory rules, in order to work for investor protection.

(7) Compliance with Credit Rating Company Regulations

- 1) Regarding credit rating agencies, the FSA places priority on examining whether systems are developed to prevent conflicts of interest and ensure fairness of rating processes, whether information concerning the rating policy is appropriately disclosed, etc.
- 2) The FSA also checks whether securities companies provide appropriate explanations regarding ratings issued by unregistered ratings companies. Moreover, the FSA urges each securities company to recognize the limitations of ratings and conduct credit risk evaluations which do not rely on ratings. This includes conducting own supplemental analyses in addition to ratings, and providing them to investors.

(8) Initiatives against Financial Crimes

- 1) There are still cases of solicitations for unlisted shares and fraudulent solicitation for interests in collective investment schemes (funds). The law was revised this May to make the sale of unlisted shares by unregistered business operators invalid in principle, prohibit such advertising and solicitation, and provide severer penalties against unregistered business operators. In view of this, the FSA is strengthening its initiatives in cooperation with the police authorities. The FSA will also appropriately deal with unregistered business operators located outside of Japan who solicit domestic investors for financial instruments.
- 2) Many inappropriate cases are seen, for example (1) registered financial instruments business operators and Specially Permitted Businesses for Qualified Institutional Investors engage in businesses which require additional registration other than their registered business or permitted business, or (2) their names are lent to unregistered business operators. In accordance with the laws and regulations, the FSA deals with such cases which inevitably damage confidence in financial instruments business.
- 3) To prevent crimes related to financial transactions, particularly fraudulent solicitations for unlisted shares, and collective investment schemes (funds), the FSA encourages appropriate initiatives by relevant industry organizations (self-regulatory organizations) and financial instruments business operators.