

Main Topics Presented by the Financial Services Agency (FSA) at a Dialogue with the Industry Association

Held on June 18, 2024, with the Japan Securities Dealers Association (JSDA)

1. Results of the Monitoring of Securities Business for the 2023 Program Year

(Major securities companies)

< Customer-oriented business conduct >

- The amended self-regulatory guidelines concerning complicated structured bonds, etc. was put into effect in July 2023. We understand that securities companies have individually developed their own systems for solicitation and sale of complicated structured bonds in line with the new guidelines. Some companies prohibit solicitation targeting individual customers in principle, but large securities companies are requested to take appropriate measures continuously so as to ensure that they refrain from proposing or soliciting the conclusion of contracts for transactions of structured bonds to customers, irrespective of individual customers or corporate customers, who do not have positive needs or prospects for the trends of reference indices.

< Governance in overseas business >

- Major securities companies have been active in expanding business overseas. However, looking at internal audit results, matters of great significance are occasionally pointed out mainly regarding overseas business entities in particular. In addition, there are also cases in which headquarters' control over overseas business is not working properly. For example, overseas business entities have failed to make reports to the headquarters in Tokyo appropriately on a timely basis. Major securities companies should further endeavor to develop effective governance and risk management frameworks commensurate with their business strategies.

(Regional securities companies)

- In PY2023, the FSA had in-depth dialogues with regional securities companies on such themes as the development of proper systems for customer-oriented business

conduct and challenges in business models, etc. through top hearings and meetings, etc. held by the JSDA.

- As a result, it was confirmed that regional securities companies have reviewed their conventional evaluation systems placing too much emphasis on employees' business performances or sales and solicitation systems for risk-involving financial instruments with the aim of ensuring customer-oriented business conduct and that some made a shift from a flow-based business model to a stock-based business model.

In addition, some formed business alliances with companies in different business categories, such as insurance companies and those handling inheritance procedures, for mutually introducing customers depending on customers' life stages, or in response to customers' increasing needs for asset management.

Securities companies affiliated with regional banks have reviewed their standards concerning customer introduction from banks, and some segmented their customer services and changed their business styles from a product-oriented one to one centered on portfolio proposals.

- In the meantime, regional securities companies face problems, such as the aging of customers and sales personnel, labor shortage, and high system cost. Accordingly, there are also moves for business transfer, conversion to IFAs, and scale-down or restructuring of regional bank groups' securities business.

(Financial instruments intermediary service providers)

- In PY2023, the FSA conducted a questionnaire survey targeting some securities companies with regard to how they manage operation systems and compliance systems of financial instruments intermediary service providers to which they outsource businesses and the status of their efforts for ensuring customer-oriented business conduct, and verified the responses.
- As a result, it was confirmed that upon concluding outsourcing contracts with financial instruments intermediary service providers, securities companies check their compliance systems and conformity to the Principles for Customer-Oriented Business Conduct, conduct screening of transactions and marketing by extracting accounts requiring attention, and provide sales personnel with practical training on

such themes as investment solicitation in line with the principle of suitability and asset management based on long-term, installment, and diversified investments. Additionally, some securities companies make it a rule to cancel contracts when any violation of laws or regulations or sales activity against the Principles for Customer-Oriented Business Conduct is found.

Furthermore, there are also cases where securities companies reviewed their conventional compensation and evaluation systems for financial instruments intermediary service providers that had reflected net increases in deposited assets and the status of compliance, and recommend balance-linked fee businesses, thereby endeavoring to ensure customer-oriented business conduct.

2. Development of Structured Bonds and Other High-risk Financial Instruments

- The FSA conducted a survey on financial institutions that develop structured bonds and other high-risk financial instruments, with regard to their frameworks for the development and wholesale of such financial instruments, screening of distributors, and management of the products they handle. The FSA found that they have been taking certain measures, for example, screening the sales framework of their partner distributors, to ensure proper sales of the products they develop.
- For further enhancing their framework, financial institutions are expected to take autonomous efforts, such as providing more specific information voluntarily and continuously to distributors depending on the complexity of the financial instruments they have developed, checking themselves whether their financial instruments are actually sold to the customers they had envisaged and continuously verifying trends after sale, including changes in the risks of financial instruments and customers' complaints, and reducing or limiting wholesale to distributors as needed based on the results of the checking and verification.
- On the other hand, in order for developers to make autonomous efforts as mentioned above, it is important to utilize information held by distributors, such as the attributes of the end customers of the financial instruments they had developed and the end customers' complaints, when making analyses. Accordingly, distributors are also expected to communicate with developers sufficiently and actively offer support to them.

- Developers and distributors of structured bonds and other high-risk financial instruments are expected to continue to make efforts while taking into account discussions on product governance being held by the Working Group on Capital Market Regulations under the Financial System Council.

3. Solicitation of Opinions on the Draft "Discussion Paper on Management of Products, Services and Activities"

- The FSA invited comments on the draft version of "Discussion Paper on Management of Products, Services and Activities at Banks and Securities Firms," from April 26 to May 31, 2024. Based on opinions thus collected, the FSA published the final version on June 19 and the English version on July 26.
- This Discussion Paper highlights the FSA's fundamental approach to the management of products throughout their lifecycles from the perspective that the need to review and enhance financial institutions' risk management framework for products is increasing while their business environments are becoming more and more complicated and are changing rapidly.
- The FSA is considering utilizing the Discussion Paper as a material for dialogues with financial institutions, mainly major Japanese banks and major Japanese securities companies, as well as foreign G-SIBs' Japanese entities, for establishing their better practices.
- We expect top management to recognize the managerial importance of developing risk management frameworks for new products, services and activities that would make it possible to balance the speedy introduction of new business and adequate identification and assessment of their risks, and present the importance to senior management and employees in charge of the development of such frameworks. By showing such attitude, top management should prevent a situation where the right timing for introducing new business is missed due to excessively long processes or where the relevant processes are operated in mere formality.
- Major securities companies are expected to make efforts to enhance their risk management framework for new products and for existing products on an ongoing basis while referring to this Discussion Paper.

4. Publication of Financial Statements by Institutions' Affiliates

- Article 440 of the Companies Act provides that stock companies, including small ones, must give public notice of their financial statements without delay after the conclusion of the annual shareholders meeting. Financial institutions' affiliates are also subject to this provision as long as they are stock companies.
- We understand that financial institutions are properly giving public notice of their financial statements. From the perspective of ensuring company groups' business execution in conformity with laws and regulations, please check again whether their affiliates also properly give public notice of their financial statements.

5. Outcomes of the G7 Finance Track in May

- The G7 Finance Ministers and Central Bank Governors Meeting was held in Stresa, Italy, from May 23 to 25, 2024. Major outcomes related to the financial sector in the Communiqué issued after the meeting are outlined below.
 - First of all, members reiterated that a continued focus on financial stability and regulatory issues remains vital.
 - Additionally, members strongly supported the Financial Stability Board's (FSB's) ongoing work to enhance the resilience of the nonbank financial intermediation (NBFIs) sector. Members are committed to implementing the FSB's recommendations to address structural vulnerabilities from liquidity mismatch in Open-Ended Funds (OEFs), together with the International Organization of Securities Commissions' (IOSCO's) guidance, and encourage ongoing FSB efforts in collecting data that are necessary for monitoring leverage.
 - On cybersecurity, members presented their continued commitment to strengthening cyber resilience in the financial sector. Members welcomed the successful completion of the cross-border coordination exercise that the G7 Cyber Expert Group (G7 CEG) conducted in April 2024, and asked the G7 CEG to further advance its work to improve the financial sector's preparedness and response capacity to cyber threats.
 - On crypto assets, members showed support for the Financial Action Task Force's (FATF's) initiatives on accelerating global implementation of its standards and its work on emerging risks, including from DeFi arrangements and peer-to-peer

transactions. Regarding the implementation of FATF standards, members supported the implementation status table published in March 2024. The commitment to implementing effective regulatory and supervisory frameworks consistent with the FSB's recommendations, which was included in the G7 Finance Ministers and Central Bank Governors Meeting' Communiqué issued in Niigata in May 2023, was reconfirmed.

- Lastly, discussions are being continued on the natural catastrophe insurance protection gap, which was raised as one of the priorities in the Japan G7 presidency in 2023. Members welcomed a High-Level Framework for Public-Private Insurance Programmes against Natural Hazards as a framework supporting the governments' initiatives, in consideration of the need for collaboration in a wide range of areas among related parties both in the public and private sectors. This framework was developed by the G7 with the OECD and the International Association of Insurance Supervisors (IAIS).
- The FSA will continue to communicate with financial institutions and contribute to global discussions.

6. IMF's Financial Sector Assessment Program (FSAP)

- From April 2023 to May 2024, the IMF conducted an assessment of Japan under its Financial Sector Assessment Program (FSAP), and publicized a report on May 14, 2024.
- Through the FSAP, the IMF assesses the stability of member countries' financial sector, and major countries, including Japan, receive an assessment once every five years (the previous assessment of Japan was conducted in 2017). Under this program, systemic risks, financial regulatory and supervisory frameworks, etc. are assessed in depth comprehensively.
- In the report, the IMF highly evaluates the current status of Japan's financial system, stating that it has remained resilient through a series of shocks, aided by strong policy support and improved policy frameworks since the 2017 assessment.
- On the other hand, based on the results of a systemic risk analysis, the IMF points out vulnerabilities that exist partially and makes some recommendations on points for further improvements in Japan's financial regulations and supervision.

- The FSA appreciates the cooperation of financial institutions for the latest assessment through providing data and receiving interviews, etc. The FSA will continue its efforts for further securing the resilience of Japan's financial system, while referring to the IMF's recommendations.

7. Holding of the IOSCO Annual Meeting

- From May 26 to 28, 2024, the International Organization of Securities Commissions (IOSCO) held its annual meeting in Athens, Greece. At the meeting, discussions were held on diverse issues, including sustainable finance, fintech, and NBFI. Among them, discussions on liquidity risk management for Open-Ended Funds (OEFs), an issue closely related to the JSDA, are introduced below.
- In response to the financial market disturbance due to the outbreak of COVID-19 in March 2020, the FSB and the IOSCO have been working to strengthen the resilience of the NBFI sector. As part of such initiatives, the FSB published the "Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds" and the IOSCO published the "Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes" on December 20, 2023.
- The FSB intends to complete a stocktake by the end of 2026 with regard to the status of development of risk management structures by FSB member jurisdictions for the purpose of dealing with structural liquidity mismatch among OEFs. The Investment Trusts Association, Japan and the JSDA appear to have been deliberating on measures against liquidity mismatch by establishing study groups, but they are still expected to surely proceed with proper actions.
- Mr. ARIIZUMI, Vice Minister for International Affairs of the FSA, who has been serving as Vice-Chairman of the IOSCO Board since October 2022, was reappointed as Vice-Chairman at this year's annual meeting. The FSA will continue making a positive contribution to discussions at the IOSCO.

8. Ensuring of Customer-Oriented Business Conduct

- In PY2023, based on the Principles for Customer-Oriented Business Conduct, the FSA monitored product governance systems and sales and management systems for individual risk-involving financial instruments, centered on foreign currency-denominated single premium policies and structured deposits.
- The FSA plans to introduce challenges, etc. that are considered to be common among distributors as found through the monitoring^(Note 1) in a report titled "Monitoring results pertaining to the implementation status of customer-oriented business conduct by distributors of risk-involving financial instruments" (published on July 5).

(Note 1) Major points to note, etc. regarding structured bonds as found through the monitoring

- According to the questionnaire survey targeting some financial institutions (major banks, etc., regional banks, and securities companies) conducted by the FSA, the sales amount and balance of structured bonds targeting individuals are decreasing, but the sales amount of private placement bonds targeting corporations has remained at a certain level.
 - Distributors are required to do the following in order to thoroughly ensure customer-oriented business conduct, in collaboration with developers as necessary:
 - take actions in line with the Self-Regulatory Guidelines to ensure appropriate solicitation and sale of complex structured bonds, etc. to customers, which were formulated by the JSDA, and
 - autonomously exercise originality and ingenuity, with the proper involvement of top management, to achieve best practices for providing customer-oriented high-quality services from the perspective of creating and developing product governance and sales and management systems, based on the Principles for Customer-Oriented Business Conduct.
 - In addition, in PY2023, the FSA plans to also publicize "the Results of the Awareness Survey of Customers Regarding Risk-Involving Financial Instruments Sales."^(Note 2)
- (Note 2) The FSA conducts this survey once every several years, and this year's survey was the third one (the results of the previous survey were publicized in June 2021).
- Top managers are expected to exercise their leadership in ensuring customer-oriented business conduct while also referring to the results of this monitoring, etc.

9. Immediate AML/CFT Measures

- Regarding AML/CFT measures, the FSA has requested that all financial institutions shall complete establishing AML/CFT framework and satisfy all the required actions written in the AML/CFT Guidelines by the end of March 2024. We appreciate the efforts you have made so far.

- Financial institutions need to verify the effectiveness of the AML/CFT measures that they have established and started to implement, and enhance and maintain their effectiveness through repeated improvements.
- Top managers should consider the management systems that they have developed by the end of March 2024 as the starting point and take measures to enhance the effectiveness of the systems on an ongoing basis.
- The FSA would like to deliberate on whether it is possible to compile certain perspectives and ideas concerning the verification of the effectiveness for the purpose of providing references and having financial institutions share best practices.

10. Countermeasures against Investment Scams, etc.

- Recently, damage caused by phishing and investment scams via SNS by impersonating prominent people, etc. is increasing rapidly. Accordingly, the national government compiled the “Comprehensive Measures for Protecting People from Fraud” on June 18, with the aim of coping with such crime.
- Based on the details of the Comprehensive Measures, the FSA will strengthen measures to prevent damage caused by fraud and other types of financial crime, in collaboration with relevant ministries and agencies. We appreciate your continued cooperation.

11. Next Cybersecurity Self-Assessment (CSSA)

- Regarding the self-assessment concerning cybersecurity using the check sheet (Cybersecurity Self-Assessment (CSSA)), which has been conducted every year since FY2022, the FSA is now preparing for the implementation for FY2024 and is planning to issue a request for self-assessment to individual financial institutions via relevant associations around late June.

* The results of FY2023 CSSA were publicized on the FSA's website in April 2024. (<https://www.fsa.go.jp/news/r5/cyber/20240423.html>) (in Japanese)

- Top management should check the status of their own cybersecurity, including the system, personnel, budgets, and human resources development, by fully utilizing the

check sheet and lead their organization's efforts for improvements. The results of self-assessment will be tabulated and returned to individual financial institutions.

12. National AML/CFT/CPF Action Plan(PY2024-PY2026)

- On April 17, the government's new action plan for AML/CFT/CPF measures was formulated and publicized on the website of the Ministry of Finance.
- The new action plan compiles initiatives to be implemented by the national government and financial institutions during the coming three years. In the financial sector as well, it is necessary to promote joint efforts by the public and private sectors to steadily strengthen and enhance AML/CFT/CPF measures through a risk-based approach.
- Under past action plans, financial institutions have made efforts mainly to develop basic management systems by setting deadlines. However, from now on, you are expected to further enhance the effectiveness of those systems, as mentioned above, and make efforts so that you can respond to changes in the risk environment, including the further sophistication of financial crime.

13. Japan Weeks 2024

- For Japan Weeks, which are to be held in the autumn of 2024 as part of the national government's initiatives to promote Japan as a leading asset management and financial center of the world, a dedicated website was launched in May.
- The content of the website will be updated. Please keep an eye on it. Entities that intend to hold an event during Japan Weeks are requested to provide relevant information to the Strategy Development Division of the FSA as needed.

(Reference) Website for Japan Weeks 2024:

https://www.fsa.go.jp/internationalfinancialcenter/lp/japanweeks2024/index_en.html

14. Asset Management Forum

- With the aim of promoting the measures stated in the Policy Plan for Promoting Japan as a Leading Asset Management Center, which was publicized at the end of

2023, in line with the needs of relevant businesses and investors in and outside Japan, the Asset Management Forum will be established on October 3 during Japan Weeks. At the Forum, dialogues will be held among domestic and foreign related parties and information on the attractiveness of the Japanese market will be distributed.

- Recently, the outline of the Asset Management Forum and related events was publicized and the solicitation of members was commenced. We would like to call your attention as the Forum will mainly consist of domestic and foreign financial instruments business operators and institutional investors. For details, please make inquiries with the Strategy Development Division of the FSA or Bloomberg L.P., which serves as the secretariat for the Forum.

(Reference) Website for the Asset Management Forum: <https://english.amforum.jp/>

15. Asset Owner Principles

- The working group of the Cabinet Secretariat decided on a final draft of the Principles on June 3, and is planning to start seeking public comments by the end of June.
 - (i) The range of asset owners assumed by the Principles is broad and includes small and medium-sized corporate funds and university corporations. As it is necessary to disseminate the Principles even to those small-sized asset owners, we would like to ask for your cooperation for the dissemination of the Principles that will be finalized later.
 - (ii) The Principles are to be followed by asset owners, but securities companies will also be involved as the financial institutions that are the counterparties to transactions. Accordingly, you are also expected to understand the concept of the Principles and make responses in a manner to promote them.
 - (iii) The Principles contain statements to recommend the use of external experts and financial institutions, like Supplementary Principles 2-2 and 3-3. Please understand this point as well and take appropriate actions.