

Basic Inspection Policy and Inspection Program for Business Year 2009

I. Basic Inspection Policy

1. Basic Concept

The mission of the Securities and Exchange Surveillance Commission (SESC) is to conduct market surveillance in order to ensure the fairness and transparency of the Japanese markets and to protect investors. Inspection is an important tool employed by the SESC to fulfill this mission.

Considering the recent expansion of the scope of business operators subject to SESC's inspection and the current global financial crisis, it is now necessary more than ever before to conduct more flexible and effective inspections. As a result of a series of regulatory reforms, including the revision of the Financial Instruments and Exchange Act (FIEA), the scope of business operators subject to SESC's inspection has grown from several hundreds of securities firms to more than nine thousand financial instruments firms, encompassing a wide variety of different business sectors. Under such circumstances, instead of applying the same inspection method across all firms, it is important to take a "risk-based, flexible approach," which takes into account the size and risk profiles of each business type and of each operator. In addition, from the perspective of further improving the efficiency and effectiveness of inspections, it is necessary to conduct inspections focused more on the quality of the internal control system, while ensuring fair trade and the protection of the interests of the public and investors.

The inspections are conducted based on the strong expectation that financial instruments firms, which serve as market intermediaries, play a public role of gatekeepers. Together with these gatekeepers, the SESC intends to expand the depth and breadth of its market surveillance. This corresponds to the concept of better regulation, which emphasizes the importance of dialogue between regulators and the industry.

Moreover, the inspections need to be performed in such a way that responds to market changes in a timely and flexible manner; and a flexible and proactive approach should be taken toward the emerging risks to prepare for the future. The current global financial crisis is urging regulators to further strengthen their inspection and supervision of capital markets and financial instruments firms. Financial difficulties of globally operating financial instruments firms could cause considerable disruption in the markets, and possibly global systemic risk. Furthermore, the operation of today's capital markets depends heavily on IT systems. In conducting inspections, it is therefore necessary to pay due attention to the overall quality of the firms' management of risks, including the financial soundness of financial instruments firms.

To respond to these considerable changes, the SESC needs to perform more efficient and more effective inspections in pursuit of its basic mission. To that end, the SESC launched the "Project for Reviewing the Inspection Process" on September 17, 2008, and after discussions at ten meetings, announced the directions of the discussions on December 25,

2008. In the project, measures discussed for enhancing the efficiency and effectiveness of inspections included the introduction, on a tentative basis, of prior notice inspection, enhanced dialogue during the on-site inspections, and the strengthened quality control of inspections; and these measures will be put into implementation whenever they become ready, as early as the beginning of this business year. The items such as the introduction of prior notice inspection, and the enhanced dialogue with top management (exit meeting, etc.), for which directions are already being finalized, have been incorporated into the “Basic Inspection Guidelines”, which specify basic inspection items and procedures for implementing inspection, etc. The guidelines are currently undergoing public comment.

“An efficient inspection” as mentioned here indicates that the inspection harnesses and adds to the self-improvement efforts of financial institutions, built on their enhanced internal control systems and forged by market discipline. “An effective inspection” indicates that it leads to sustainable improvement in the firms’ internal control systems, and to the confidence of market participants. Needless to say, indispensable elements to such inspection are two-way dialogues with financial instruments firms, and close coordination with relevant regulatory agencies.

More specifically, the SESC’s efficient and effective inspection will be achieved on the following terms:

- 1) Taking the basic approach of verifying conducts in violation of laws, regulations and market rules, and in consideration of the protection of the interests of the public and investors, to focus also on verification of appropriateness of the internal control systems, etc. of financial instruments firms, which could possibly be a factor in causing violations, taking into account the size and characteristics of those firms.
- 2) To take a sharper risk-focused approach, with a more forward-looking mind-set, in selection of financial instruments firms to be inspected, as well as of areas to be inspected.
- 3) To put more emphasis on interactive dialogues with the financial instrument firms, including holding meetings with top management during on-site inspections, etc., with a view to encouraging their voluntary efforts toward developing stronger internal control functions.
- 4) To enhance transparency and predictability in inspection methodology, for example, through the publication of the revised “Inspection Manuals for Financial Instruments Firms.”

The recent subprime loan crisis has revealed the global extent of focuses of the securitized instruments market and its attendant risk management issues. One of the SESC inspection’s focuses will thus be on the securitization process, namely underwriting examination, risk management, sales management and other related control systems of financial instruments firms that arrange, underwrite, and market such securitized instruments.

Following the revision of the FIEA to relax the firewall regulations among securities firms, banks and other firms on the condition that their internal control systems for managing conflict of interest be enhanced, the SESC will accordingly look into this new area of disciplines.

Furthermore, the SESC intends to continue issuing recommendations to the FSA, where

necessary, on required disciplinary actions based on its individual inspection results. The Commission will also monitor developments in financial and capital market rules, and will forward policy proposals to the FSA, as necessary.

2. Implementation Policy of Inspection for Business Year 2009

(1) Achieving an efficient and effective inspection

1) In-depth inspection focused on risks

More flexibility and efficiency will be added to inspection programs, by focusing more sharply on risks. By collecting and analyzing information on the financial and capital market trends, the SESC will flexibly select and prioritize financial firms to be inspected, considering their inherent problems and positions in the market. Where cross-sectoral issues related to the financial and capital markets are identified, special inspection with a cross-cutting theme (a thematic review) will be conducted. A special inspection (a follow-up inspection) will also be implemented to verify the improvement of problems stated in a business improvement order, or pointed out in a previous inspection.

2) Enhancement of cooperation with relevant regulatory agencies

The SESC will reinforce its back office supporting functions for its inspectors, in order to improve the efficiency and effectiveness of inspection. In addition, the Commission will extend its capabilities to provide support for the Local Finance Bureaus, as well as promote joint inspection and the exchanges of inspectors, to further the sharing of inspection methodologies and problem awareness with inspectors in the Local Finance Bureaus.

Furthermore, in order to properly perform inspections of financial instruments firms that operate globally and trade highly complex financial instruments in the increasingly globalized market, the SESC will further improve cooperation with relevant regulatory agencies to enhance the sharing of problem awareness and of viewpoints.

- The SESC will collaborate with Supervisory Departments in the FSA to promote the mutual sharing of problem awareness and information. The Commission will also, under the proper division of roles, exchange information that is obtained through supervision yet is equally useful for inspection, and information that is obtained through inspection but is equally useful for supervision.
- The SESC will promote necessary cooperation with the Inspection Bureau of the FSA. The two bodies will share problem awareness, and, if required, implement simultaneous inspection, and exchange information on financial instruments firms that constitute a financial conglomerate, to achieve efficient and effective inspection.
- The SESC will work with Self Regulatory Organizations (SROs) to enhance necessary collaboration, and exchange information on both regular and ad-hoc bases, in order to ensure that their industrial and self-regulatory functions are well in place.
- The SESC will enhance cooperation with overseas regulators, through the exchanges of information on foreign affiliated firms and domestic firms with overseas bases that are subject to inspections. In addition, the Commission will strengthen the cooperation with the relevant overseas regulators through more active involvement in the “Supervisory College,” which is planned to be set up for each of the major international

financial institutions.

3) Publication of the Revised Basic Inspection Guidelines and Inspection Manuals

From the perspectives of implementing efficient and effective inspections and lightening the burdens of firms that receive inspections, and in relation to the measures considered in the above-mentioned “Project for Reviewing the Inspection Process,” the items such as the trial introduction of prior notice inspection and the meeting with top management, of which directions are fixed to some extent, have been incorporated into the “Basic Inspection Guidelines.” The guidelines are currently undergoing public comment. In addition, the revision of the FIEA relaxed the firewall regulations, including the restriction on concurrent executive positions within a financial group. At the same time, the revised law requires such a group to strengthen its conflict of interest management system, as a part of the group-wide internal control system. The SESC, mandated to inspect these new disciplines, incorporated these perspectives into the “Inspection Manuals for Financial Firms” and put it out for public comments.

4) Verification of self-improvement efforts of financial instruments firms (appropriate internal control system)

When identifying any deficiencies in firms’ business operations, the SESC will not only verify their compliance with explicit rules, but also assess the quality of their internal control system, with reference to the criteria published in the Inspection Manuals, “The Model Management of Financial Instruments Firms.” As a firm’s internal control system is an important element in assessing the basic posture of the firm, the Commission will verify the effectiveness of its functioning. Any deficiencies will be assessed in light of the responsibility that the firm as a whole should assume.

5) Focus of a group-wide inspection

In a group-wide inspection focused on intra-group transactions, the SESC will verify the quality of the internal control function, regarding the handling of customer information and the management of conflicts of interest. Particularly, as the revised FIEA requires financial groups to improve their conflicts of interest management systems, the SESC will verify their effectiveness, in terms of, for example, whether or not customers’ interests are unduly undermined by group companies’ transactions. Furthermore, the Commission may take account of the entire group of an inspected firm, including its holding company, to assess whether the firm is subject to any undue influence from any other companies in the group.

(2) Areas of inspection focus

1) Verification of market intermediary functions of financial instruments firms

To develop and maintain a fair, transparent and high quality financial and capital market, it is extremely important that financial instruments firms play the role of gatekeepers. They are expected to prevent the market participation of those who intend to abuse and misuse the market, through the adequate management of customers, trade examination, underwriting examination (due-diligence) and other activities. The SESC will verify whether and to what extent they are playing appropriately their roles.

As a part of this assessment, the SESC will verify how inspected financial instruments firms are developing their information gathering systems to prevent transactions by anti-social forces. Regarding suspicious transaction reporting, the Commission will verify the institutional effectiveness of the firms' checking systems, including the development of internal screening criteria. Also, the SESC will inspect whether the identity verification measure is properly implemented at the time of opening securities accounts.

Furthermore, to encourage the adequate functioning and the healthy development of capital markets, the Commission will assess whether underwriting operations, including due diligence, information management, trade management and distribution are appropriately executed from the viewpoint of protecting investors. As for financial instruments firms that arrange, underwrite and market the securitized instruments such as CDOs and high risk derivative products, the SESC inspection will focus on their underwriting examination, risk management and sales management systems.

Moreover, the SESC will verify whether the firms are consistently and properly controlling IT system risks and other operational risks, to prevent system failures and other problems from hindering the smooth operation of securities transactions.

2) Verification of risk management systems of financial instruments firms

While maintaining its basic approach of verifying conducts in violation of laws and regulations, the SESC will also conduct inspections focusing on risk management systems wherever necessary.

There are various risks such as credit risk, liquidity risk and market risk, etc. Since the operation of today's capital markets depends heavily on the IT systems, it is necessary to pay attention to the IT operational risk. Furthermore, in the current globalized capital market, it is important to pay attention to impacts on the market, including the systemic risk. When conducting inspections of globally operating financial instruments firms in particular, the SESC will therefore verify the overall quality of the firms' management of risks, including the IT operational risk and the financial soundness of financial instruments firms.

When conducting inspections of financial instruments firms that are engaged in foreign exchange margin trading, the SESC will verify the appropriateness of segregation and their risk management systems, including the maintenance of financial soundness.

3) Verification of the management of undisclosed corporate information (Prevention of unfair insider trading)

In order to prevent unfair insider trading, the Commission will verify whether financial instruments firms and registered financial institutions are properly managing undisclosed corporate information. More specifically, the SESC will verify whether the firms are establishing an effective management system, involving the registration of corporate information, the restriction on stock trading by officers and employees, the firewalls of the information access, and the trading examination.

4) Verification concerning appropriateness of asset management business

While asset management firms are commissioned by investors to manage assets in the interest of investors, it is very difficult for individual investors to directly check the state of management firms. Accordingly, the SESC will inspect asset management firms' compliance with the relevant rules, including fiduciary duty, and prudent management duty, to protect the interest of investors. Particularly, in the case of asset management firms that manage assets of real-estate investment companies, the Commission will focus on the compliance with the relevant rules, including prudent management duty concerning the acquisition of assets from related parties, etc., as well as the effectiveness of their conflict of interest management systems and due-diligence.

5) Verification of conduct that may hinder fair price formation

Fair price formation underlies the development of fair, highly transparent and healthy financial and capital markets. The SESC will inspect not only misconduct that may hinder fair price formation, but also the effectiveness of trade management systems of the firms. At the same time, the SESC will verify management systems regarding short selling (including management of delivery failures) on an as-needed basis.

As for financial instruments firms operating online trading, or providing electronic facilities for DMA (direct market access), the Commission will verify to what extent their trade management systems are adequately adapted to the peculiar nature of the electronic transactions, i.e., whether they can feed customer orders directly and instantly into the market.

6) Verification concerning the state of soliciting investors and customer care

To protect investors and secure fair sales attitudes, the SESC will assess whether or not investors are appropriately solicited, as well as verify the status of customer care. Regarding the verification concerning the state of soliciting investors, the Commission will verify whether accountability is fulfilled, especially in terms of the sustainability rule, taking full account of customers' knowledge and experiences, and other factors. In addition, the SESC will verify whether there are any indications in advertisements, the means by which investors first access the financial instruments, that may cause misperceptions about its investment effects and changes in market forces.

Concerning the verification of the status of customer care, the SESC will verify whether financial instruments firms' operations are properly conducted under the Book-Entry Transfer System for Stocks, etc., after the transition to the electronic share certificate system.

7) Verification for the appropriate exercise of function of SROs

As for SROs, the SESC will verify whether self-regulatory operations are satisfactorily effective, whether their functions are appropriately executed, and whether they have a system to adequately execute functions. Specifically, the Commission will verify the establishment of their self-regulatory rules for their members, and their regulatory enforcement, such as on-site and off-site reviews, penalties, and listing examination and management. In verifying listing examination and management, the SESC will focus on SRO's measures designed to prevent anti-social forces from intervening in their markets, including the collection of information on the involvement of anti-social forces in issuing and listed companies.

Furthermore, in consideration of the significance of exchanges as a part of market infrastructure, the Commission will focus on the verification of whether they are establishing an appropriate and effective management system for IT system risks and other risks.

- 8) Verification concerning financial firms to be newly inspected, and new financial instruments

In line with the recent expansion of the scope of inspection, the SESC intends to make continuous efforts to gain knowledge and understanding on the situations of firms and instruments, which became newly subject to inspection, including collective investment schemes (investment funds), and to develop inspection methods and expertise, to protect the interest of investors. In addition, the SESC will also make efforts to gain knowledge and understanding on the situations concerning financial instruments firms that trade new financial instruments on an as-needed basis.

- 9) Improvement of problems identified in previous inspections

There have been a limited number of cases where the inspected firms were not forthcoming in improving the deficiencies identified by the inspections. The SESC will thus systematically verify the improvement of issues pointed out in the previous inspections, and will deal strictly with the cases where similar problems are recurring.

II. Basic Inspection Program

Type I Financial Instruments Businesses and Registered Financial Institutions.:
130 firms (including 110 firms to be inspected by the Local Financial Bureaus)

Asset management firms and Investment advisories/agencies:
65 firms (including 35 firms to be inspected by the Local Financial Bureaus)

Self regulatory organizations: To be inspected as needed

Type II Financial Instruments Business Operators, etc: To be inspected as needed

(Note 1) The above-mentioned figures are subject to change, as a result of changes in the inspections program, including the implementation of special inspections.