

I. Outline

1. *Significance of inspections and parties inspected*

The SESC conducts on-site inspections of securities companies and related organizations, such as SROs, to supervise compliance with laws and regulations concerning the maintenance of fairness in securities and financial futures transactions. SESC inspections are carried out under the authority delegated by the Minister of Finance as prescribed in the SEL, LFSF and FFTL.

The objective of SESC inspections is to protect investors and public interests. SESC inspections support the Minister of Finance in executing necessary measures and policies concerning securities companies.

The SESC's authority to inspect and seize reports and materials is entrusted to directors-general of regional finance bureaus. (If necessary, however, the SESC may exercise this authority independently.)

Specifically, the following institutions are subject to SESC inspection:

| | |
|--|-----------------------|
| Securities companies and other organizations and their parent financial institutions | (SEL, Article 56) |
| Financial institutions licensed to provide securities services | (SEL, Article 66) |
| Japan Securities Dealers Association | (SEL, Article 79(15)) |
| Stock exchanges | (SEL, Article 154(2)) |
| Branches of foreign securities companies and specified financial institutions | (LFSF, Article 21(2)) |
| Financial futures exchanges and their members | (FFTL, Article 52(2)) |
| Financial futures dealers | (FFTL, Article 77(2)) |
| Japan Financial Futures Dealers Association | (FFTL, Article 90(2)) |

Note: Information in parentheses indicates provisions for delegation of inspection authority.

2. *Scope of inspections*

The scope of SESC inspections is regulated in the Cabinet Order (SEL Enforcement Order Articles 16, 17(5), 18(2) and 19(2); LFSF Enforcement Order Article 14; and FFTL Enforcement Order Articles 3, 4,

7 and 10). For example, the SESC is authorized to conduct inspections related to violations of laws and regulations by securities companies and their directors and employees (including discretionary trading account transactions, solicitation with definitive pre-

dictions and solicitation with promises of special profit), as well as such violations as loss compensation and guarantees, market manipulation and insider trading.

II. Basic Policy and Plan of Inspections

Inspection periods are based on SESC years, from July 1 to the following June 30.

Basic policies and plans for inspections are established each SESC year, in order to strategically manage and conduct all inspections by the SESC and, under SESC authority, by directors-general of regional finance bureaus.

Basic policies for inspections determine priority inspection topics and other topics that form the basis of inspections. Basic plans for inspections determine such matters as the numbers and kinds of domestic and foreign securities companies, and financial institutions licensed to provide securities services to be inspected during the year.

The SESC's basic policy and plan of inspections during SESC year 1996 (year under review) were decided on July 4, 1996, as follows:

Basic policy and plan of inspections in SESC year 1996

1. Basic policy of inspections

Despite some positive signs, such as general improvement in stock markets owing to a growing sense of optimism regarding stabilization of currency exchange rates and economic recovery, the securities industry faced difficult conditions as the performance gap between securities companies further widened. Moreover, ongoing relaxation of regulations covering securities markets has enabled securities companies to diversify their marketing activities. At the same time, their roles and responsibilities as market intermediaries are becoming more profound than ever before.

The results of inspections carried out in SESC year 1996 reveal general improvement, compared with the previous year, as companies worked to strengthen and build up their internal control systems. However, some cases of legal violations, committed by securities companies and their directors, were uncovered, due to insufficient awareness and misinterpretation of rules. In addition, some securities companies were found to have engaged in practices that ignore the attributes of customers, as well as other inappropriate transactions. These include solicitation to invest in convertible bonds, foreign bonds and other instruments. In addition, the

SESC found some problems related to internal control systems, such as insufficient deployment of systems and lack of awareness of compliance with laws.

Given this situation, the priorities for inspecting securities and related companies for the year under review were set forth as described below and with the goal of conducting strict and precise inspections in cooperation with the Financial Inspection Department of the Ministry of Finance.

Moreover, to promote the quality of inspections it was decided to continually reinforce and improve the SESC's inspection organization while enhancing inspection procedures.

(1) Priorities for inspections of securities companies

① To maintain fairness in securities transactions, inspections were to examine compliance with market rules from various points of view.

② Inspections were to sufficiently check the sales practices of securities companies, including investment solicitation methods, to ensure maintenance of sound sales practices.

③ To maintain the credibility of securities services, inspections were to fully examine internal control

systems and effectiveness of various securities companies.

(2) Priorities for inspections of financial futures dealers

To maintain fairness in financial futures transactions, inspections of dealers were designed to examine compliance with market rules and to fully comprehend the sales practices of dealers concerning investment solicitation.

2. Basic inspection plans

(1) Inspections of securities companies

| | |
|---------------------------------|----|
| ❑ Domestic securities companies | 82 |
| ❑ Foreign securities companies | 1 |

Notes:

1. In addition to the above domestic securities companies, 23 individual branch offices of securities companies were to be inspected.

2. Specific targets of inspection are selected upon fully considering such matters as time elapsed since previous inspection and results of previous inspection, and attention was also paid to the continual smooth implementation of inspections.

3. For the securities subsidiaries of financial institutions,

proposals were to be made regarding such matters as time elapsed since commencement of operations, and inspections were to be carried out of firewall violations and other incidents.

4. In principle, SESC inspections were to be conducted in conjunction with those of the Financial Inspection Department.

5. The above number of companies to be inspected was the initial figure and was subject to change according to various factors.

□ Financial institutions licensed to provide securities services

In principle, SESC inspections were to be conducted at the same time as those of the Financial Inspection Department.

(2) Inspections of financial futures dealers

□ Financial futures dealers

In principle, SESC inspections were to be conducted in conjunction with those of the Financial Inspection Department.

III. Status of Inspections

1. Inspection status

Following are the inspections conducted by the SESC and regional finance bureaus during SESC year 1996.

(1) Inspections of securities companies

In the year under review, the SESC and regional finance bureaus commenced inspections of 83 securities companies, and seven financial institutions licensed to provide securities services.

Of this total, the SESC commenced inspections of 12 domestic securities companies and four branches of three foreign securities companies. Regional finance bureaus commenced inspections of 68 domestic securities companies and seven financial institutions licensed to provide securities services.

Regarding inspections commenced during the year under review, Notifications of Conclusion had been presented to and inspections had been completed on 52 domestic securities companies, two branches of one foreign securities company, and six financial institutions (Table 2). In addition, inspections commenced in SESC year 1995 that had not been completed by June 30, 1996, were completed during the year under review. These included inspections of 24 domestic securities companies, four branches of two foreign securities companies, and one financial institution licensed to provide securities services.

Following SESC recommendations based on inspections concluded in SESC 1996 (including those commenced in the previous year), the Minister of Finance enacted administrative disciplinary actions, such as suspension of operations, against 12 directors and employees of securities companies for grave violations of laws and regulations (detailed on pages 11 to 15).

Problems found through these inspections were reported to the Ministry of Finance, which then issued improvement directives to the securities companies involved.

(2) Inspections of financial futures dealers

In SESC year 1996, inspections of financial futures dealers were carried out in conjunction with securities inspections.

Table 2: Inspection Status

| Category | SESC Year 1992 | SESC Year 1993 | SESC Year 1994 | SESC Year 1995 | SESC Year 1996 |
|--|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Securities companies | 84 | 87 | 85 | 86 | 83 |
| Domestic (SESC) | 78 (9) | 79 (9) | 79 (10) | 84 (9) | 80 (12) |
| (Regional finance bureaus, etc.) | (69) | (70) | (69) | (75) | (68) |
| Foreign (SESC) | 6 (6) | 8 (8) | 6 (6) | 2 (2) | 3 (3) |
| (Regional finance bureaus, etc.) | (-) | (-) | (-) | (-) | (-) |
| Branch inspections | 17 | 17 | 22 | 15 | 26 |
| Financial institutions licensed to provide securities services (SESC) | 11 (3) | 13 (3) | 11 (1) | 10 (0) | 7 (0) |
| (Regional finance bureaus, etc.) | (8) | (10) | (10) | (10) | (7) |

- Notes:
1. All inspections of foreign securities companies were carried out by the SESC.
 2. In addition to the above, regional finance bureaus conducted separate inspections of 26 branches of securities companies under supervision of the Ministry of Finance (19 of these inspections were completed).
 3. In principle, inspections of financial institutions licensed to provide securities services are carried out in conjunction with inspections of securities companies.

2. Total personnel per inspection

In SESC year 1996, 109 man-days were assigned per inspection (on-site basis) for domestic securities com-

panies, 81 man-days for foreign securities companies, and 12 man-days for financial institutions licensed to provide securities services (see Table 3).

Table 3: **Total Personnel per Inspection**

(Unit: man-days/inspection)

| Category | SESC Year 1992 | SESC Year 1993 | SESC Year 1994 | SESC Year 1995 | SESC Year 1996 |
|--|----------------|----------------|----------------|----------------|----------------|
| Securities companies | | | | | |
| Domestic | 103 | 111 | 108 | 107 | 109 |
| Foreign | 60 | 43 | 47 | 105 | 81 |
| Financial institutions licensed to provide securities services | 16 | 20 | 15 | 14 | 12 |

Note: Figures for man-days are calculated according to an on-site basis.

IV. Results of Securities Company Inspections

1. Problems acknowledged through inspections

Inspections of securities companies in the year under review were conducted mainly to confirm implementation of directives from previous inspections, as well as to examine compliance with transaction rules, sales practices and internal control systems.

Among the 86 companies of which inspections were completed, problems were found at 38 compa-

nies. Of the 38, inspections found problems related to transaction rules, such as legal violations, as well as numerous problems related to sales practices and internal control systems. These inspections revealed insufficient understanding of transaction rules, disregard for the attributes of customers and other factors, and show a need for improved internal control systems, as well as a more thorough fundamental understanding by directors of securities companies of compliance with laws.

Analyzing problems related to compliance with

transaction rules, the SESC noted cases of conclusion of discretionary trading account transaction contracts and legal violations related to securities trading for pursuit of speculative profit, as well as numerous instances of violations of internal rules. In addition, the SESC uncovered a new case concerning the securities subsidiary of a bank, whereby information relating to a company planning a public share issue was obtained from the parent company prior to the public disclosure of said information.

Several cases of problems related to solicitation to invest were found, especially among companies under supervision of the Ministry of Finance (excluding foreign securities companies and securities subsidiaries). These included solicitation that disregards the profit of customers and insincere or unfair business practices, such as inappropriate inducement to sell foreign bondholdings in order to purchase new issues being marketed by the securities company.

Despite measures adopted by various companies to strengthen their internal control systems, there were several problematic examples. These included failure to sufficiently comprehend the will of the customer and the nature of the inducement to invest, due to the perfunctory manner of customer meetings and branch office guidance, as well as failure to report mistakes despite knowing that a legal violation had occurred. These examples illustrate that control systems have not been deployed accurately or effectively, and that persons directly involved in controlling such systems acted with insufficient intention to comply with laws and rules.

Following is a summary of problems found during inspections completed in SESC year 1996, including those commenced in the previous SESC year:

(1) Concerning the observance of transaction rules, the following problems were found in some securities companies:

Making recommendations in legal violation

- ① Conclusion of discretionary trading account transaction contracts
- ② Submission of falsified reports on securities trading
- ③ Securities trading transactions for speculative profit
- ④ Acceptance of undisclosed information about scheduled securities issues from parent companies of issuers and others

- ⑤ Transactions intended to provide profits for customers to compensate for losses

Legal violation (not resulting in making recommendation)

- ⑥ Purchase of securities by original underwriter for own account during stabilization period (see page 26)

Violations of administrative guidance

- ⑦ Loss compensation prior to revisions in the SEL

Violations of self-regulatory rules

- ⑧ Recommendation to purchase securities based on information not yet disclosed to the public (see page 28)
- ⑨ Purchase of securities by original underwriter for own account during purchase-restricted period (see page 26)
- ⑩ Trading of bonds at prices exceeding margin limit
- ⑪ Inappropriate submission of transaction balance and other reports
- ⑫ Unauthorized trading by sales representatives
- ⑬ Conducting margin transactions and accepting orders under borrowed names
- ⑭ Accepting orders for transactions under assumed names
- ⑮ Lending and borrowing account names for securities transactions
- ⑯ Lending money to and borrowing money from customers
- ⑰ Purchase of securities by original underwriter for own account during investment inducement provision period (see page 26)
- ⑱ Conducting delayed-settlement transactions not validated by the contract

(2) Concerning sales practices, the following problems were found in some securities companies:

- ① Aggressive solicitation related to foreign currency bond (including dual-currency bond), convertible bond, foreign securities and other transactions that disregard

the profits of customers;

- ② In transactions between customers and securities companies to realize unrealized gains, adjusting losses and gains from said transactions through other transactions with the same customer;

- ③ Improperly taking custody of stock index options

and others;

- ④ Improper receipt of orders for stock transactions from investment advisory companies.

(3) The following problems related to internal controls in some securities companies have been acknowledged:

- ① Insufficient internal control systems;
② Insufficient awareness of directors for compliance with laws and regulations.

2. Examples of problems

Facts regarding the above problems are described below. (Facts in cases in which the SESC has already made recommendations are described in Chapter 2.)

(1) Cases concerning compliance with transaction rules

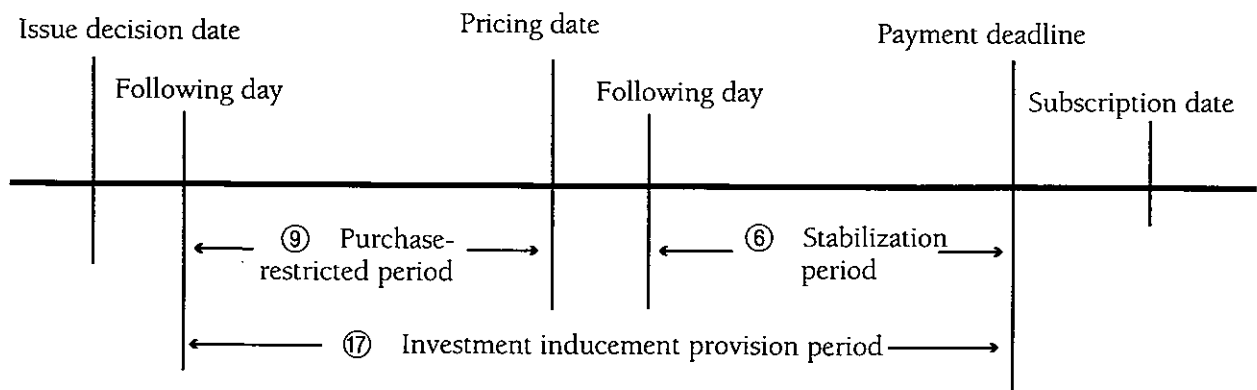
① ~ ⑤ (Discussed in Chapter 2)

⑥ A securities company, as original underwriter, traded securities for its own account during the stabilization period.

(Violation of Ministerial Ordinance 2(6), based on SEL Article 50(1)6)

Concerning several convertible bond issues for which it was original underwriter (hereinafter referred to as “Finance Issues”), Securities Company A traded such issues on its own account during said issues’ stabilization period. Such transactions do not come under “stable transactions” and “transactions for correcting mistaken orders” as recognized by law.

Purchase-restricted period, stabilization period and investment inducement provision period



Note: When a corporation conducts market-price financing—such as raising funds through stock and other issues—the price formation of the placement market during the financing period is extremely significant, for two reasons:

(1) The issue price (warrant exercise price, conversion price) and other factors are determined by the market price at time of placement, and marketing and sales activities are conducted to general investors based on that issue price; and
(2) Whether or not the issue price corresponds to the market price at time of marketing has a large impact on the judgments of investors.

The purpose of stabilization transactions is to peg and stabilize prices at market levels. Conducting multiple stabilization transactions is prohibited in principle under the SEL, although such transactions are acceptable under Cabinet order if limited to transactions intended to facilitate the placement of securities. The stabilization period, pricing and other limits, reports to the Minister of Finance and other procedures are determined by Cabinet order. Furthermore, SRO rules prohibit purchases on own account by the underwriter and related parties, as well as acceptance of purchase orders from parties related to the issuer, during the purchase-restricted period. SRO rules also prohibit underwriters from making aggressive solicitation of stock issues during the investment inducement provision period.

⑦ Loss compensation prior to SEL amendment.

(Violation of former directives of the Director-General of the Securities Bureau)

The International Division of Securities Company B opened an account and was entrusted by a related investment advisory company to conduct securities transactions. However, growing losses were incurred and, since recovery of said losses could not be foreseen, the customer issued instructions not to extend the period of the contract, due to expire in June 1991. In the four business days between the end of May and the beginning of June 1991, Securities Company B used the customer's account to conduct daily stock futures transactions on five occasions on its own account, and passed the profits to the customer.

In this loss compensation case, the incident was not included in an internal check report submitted to the JSDA in August 1992, due to insufficient supervision by the Internal Auditing Department of the International Division of Securities Company B.

⑧ Inducement to purchase stock prior to public disclosure of market allotment sale.

(Violation of TSE Regulation 46(2), OSE Regulation 44(2) and NSE Regulation 45(2))

The institutional departments of several branches of Securities Company C received information about 10 market-allotment stock issues, including some for which Securities Company C was lead manager. The information came from the issuing companies and was relayed to Securities Company C's Sales Division, which solicited purchases prior to official announcements by the relevant securities exchanges.

Note: Market allotment sale

Market allotment sales are employed in cases where the customer has entrusted large-volume orders, and general investors are invited to broadly participate, so as to assure the convertibility of such large orders. They are a form of in-market transaction adopted to avoid confusion and sudden market price swings within the trading arena.

⑨ Purchase of stocks for own account by securities company (original underwriter) during the purchase-restricted period.

(Violation of TSE, OSE and NSE Regulation 1(1), which is a Board Directive concerning Article 59, preventing exchange members from trading on own account; violation of the JSDA Fair Business Practice Regulations No. 1 related to trading and other transactions concerning OTC-registered securities, Article 20(2))

Securities Company D distributed to its Stock Division the list of issues, prepared by its Trading Inspection Division, for which it had concluded underwriting contracts. According to regulations, the company was not allowed to purchase the Finance Issue for its own account. Despite the regulations, fund managers in the Stock Division placed buying and selling orders without confirming the list. Securities Company D thus traded Finance Issue convertible bonds on its own account during the purchase-restricted period. (Refer to page 26; same violation as Securities Company E and Securities Company F, below.)

Securities Company E, mistakenly believing transactions for settlement of margin transactions conducted during the purchase-restricted period were not subject to purchase restrictions, made purchases of warrant bonds and convertible bonds of the Finance Issue for its own account within the restricted period.

Securities Company F traded Finance Issue OTC-registered convertible bonds on its own account during the purchase-restricted period. The company mistakenly believed that, similar to listed convertible bond issues, OTC-registered Finance Issues were authorized for own-account trading during the purchase-restricted period.

⑩ Trading of bonds at prices above margin limit.

(Violation of TSE Directive, related to appropriate prices for off-market bonds, concerning Article 23(2); violation of JSDA Fair Business Practice Regulations No. 3, covering regulations concerning the publication of OTC quotation of bonds, etc., and trading prices, Article 13)

Securities Company G, mistakenly believing that the actual market price arrived at through its trading activities would be the standard for calculating margin limit, conducted transactions based on the previous day's price despite the fact that the current-day price was announced by the exchange on which the bonds were listed. This resulted in execution of reversal transactions exceeding the margin limit.

Furthermore, Securities Company H mistakenly interpreted the standard indicated prices for OTC-registered issues and concluded that there would be no problem if the disparity between the indicated price and the actual prices was within certain limits. As a result, the company, responding to demands from customers to avoid losses on bond sales, executed reversal transactions exceeding the margin limit.

⑪ Inappropriate handling of account balance update report.

(Violation of JSDA Fair Business Practice Regulations No. 6, for regulations concerning receipt of securities as deposits, Articles 19(3) and 21(1))

Sales Representative A of Securities Company I repeatedly submitted account balance update reports and transaction reports to customers outside of the branch office despite requests that same be directly submitted at the branch office. In this case, the manager at the branch tolerated the actions of Sales Representative A, illustrating problems with the company's internal control systems.

⑫ Unauthorized trading by sales representatives.

(Violation of JSDA Fair Business Practice Regulations No. 8, concerning securities company employees, Article 9(3)16)

On the settlement day of a stock margin transaction, Sales Representative B of Securities Company J executed a sell order without authorization from the customers, and simultaneously executed a purchase transaction for the same issue.

⑬ Conducting margin transactions and borrowing names for securities transactions.

(Violation of JSDA Fair Business Practice Regulations No. 8, concerning securities company employees, Articles 9(3)19 and 25)

In order to cancel a no-liability account (account in which margin transactions have not been conducted for a long time despite existence of substitute securities), Sales Representative C of Securities Company K used a customer's account to conduct margin transaction trading on his own behalf, then transferred the contents to his own account and sold them.

⑭ Accepting orders for transactions under assumed names.

(Violation of JSDA Fair Business Practice Regulations No. 8, Article 9(3)24)

At the time of a new share issue, Sales Representative D of Securities Company L, while fully aware that the customer used borrowed names of multiple acquaintances and others in order to increase the possibility of gaining placement rights through the lottery system, nevertheless made applications on behalf of the same customer.

Furthermore, Sales Representative E of Securities Company M received sell orders for stocks from a customer residing in a faraway place despite knowing that the customer was executing transactions using the account of his mother, who was living close to the sales representative's branch office.

⑮ Lending and borrowing names for securities transactions.

(Violation of JSDA Fair Business Practice Regulations No. 8, concerning securities company employees, Article 9(3)25)

Sales Representative F of Securities Company N used the account of his brother, who resided in a separate place, to purchase stocks on his own behalf.

⑯ Lending money to and borrowing money from customers.

(Violation of JSDA Fair Business Practice Regulations No. 8, Article 9(3)29)

Sales Representative G of Securities Company O, without authorization, appropriated funds from the sale of a customer's stocks to his father for stock purchases, temporarily transferring his own funds to the customer's

account to partially compensate for the shortfall.

⑰ Aggressive solicitation by original underwriter for purchase of stock during investment inducement provision period.

(Violation of JSDA Fair Business Practice Regulations No. 9, Article 8(4))

A foreign subsidiary of Securities Company P was the original underwriter of a dollar-denominated issue of bonds with warrants. During the investment inducement provision period (refer to page 26), a branch of Securities Company P aggressively solicited stock in the same company making said issue of bonds with warrants, without confirming that it was a Finance Issue.

Furthermore, the Trading Inspection Division of Securities Company P failed to confirm that the stocks were a Finance Issue, due to the fact that the company was not the lead manager of the issue of bonds with warrants. As a result, the division did not comprehend the status of investment solicitation.

⑱ Execution of delayed-settlement transactions not covered in transaction contract.

(Violation of JSDA Board Directive 2(1) concerning

delayed-settlement bond and other transactions)

Due to an administrative oversight by a person handling bond transactions in Securities Company Q, delayed-settlement transactions (see Note below) were processed as normal transactions without reference to the transaction contract.

Note: Delayed-settlement transactions

Delayed-settlement transactions are bond trading transactions where current market prices apply but settlement occurs at a specified time—at least one month—in the future.

(2) Cases concerning sales practices

① Active solicitation ignoring the profits of customers.

(a) Securities Company R, faced with prolonged depression of stock markets and declining domestic interest rates, actively marketed foreign currency denominated bonds (hereinafter referred to as “foreign bonds”), open-end investment trusts and convertible bonds, in order to attract assets from individuals.

i. Switching between foreign bonds

Due to a lack of understanding on behalf of sales representatives, the currency exchange costs of switching between bonds were not sufficiently explained to the customers, and there were cases of active solicitation to switch between bonds in the same currency at multiple divisions and branches of Securities Company R. Although trading profits were recorded owing to the ongoing depreciation of the yen, an unnecessary burden was imposed by currency exchange costs (¥3 per dollar in the case of the Australian dollar), due to switching between bonds with practically identical characteristics, such as coupon and ultimate returns. As a result, the transactions were not beneficial from the customers' standpoint.

ii. Switching between select-fund-type investment trusts

Because commissions do not apply in the case of same-day switching between select-fund-type investment trusts (see Note below), representatives of Securities Company R executed multiple switching transactions on the following day, thus incurring commissions. Due to a lack of understanding about switching, or to a desire to prioritize commission sales, the representatives solicited investments while failing to sufficiently explain to customers that same-day switching does not

incur commission.

Note: Select-fund-type investment trusts

These are a form of open-end investment trust, where the investor can freely choose among a specified selection of funds. A feature of these trusts is that, under certain conditions, switching between funds incurs little (or no) commission.

iii. Cutting short-term losses through sale of below-par convertible bonds

Despite the fact that medium- or long-term holdings of below-par convertible bonds would have produced favorable returns, sales representatives of Securities Company R made repeated solicitations to customers, stressing that short-term increases in bond prices could be expected. The sales representatives then sold the bonds to cut short-term losses.

Due to the sales representatives' insufficient understanding of the nature of the bonds, or to excessive priority placed on commission income, the representatives on multiple occasions solicited investment ignoring the will and profits of customers who had little knowledge or experience with such instruments.

(b) Securities Company S decided to prioritize expan-

sion of deposits by individuals as a matter of urgency, and actively marketed convertible bonds and foreign bonds accordingly.

Securities Company S solicited the purchase of below-par convertible bonds to customers who desired medium- or long-term holdings but had little knowledge or experience. The company stressed to customers that short-term gains on bond prices could be expected, without explaining the nature of below-par convertible bonds.

Furthermore, Securities Company S also recommended medium- and long-term investments in foreign bonds to customers with inadequate knowledge about such products. At the same time, to improve its record in other instruments (investment trusts), the company on multiple occasions solicited short-term switching between funds.

(c) Although Securities Company T was strengthening its focus on the sale of foreign bonds, it failed to explain currency exchange and other costs to customers, who had inadequate knowledge and experience and desired medium- or long-term investments. The company solicited switching between instruments to emphasize short-term recovery of funds and increased returns. In the course of conducting these transactions, Securities

Company T induced certain customers to switch from bonds with a long time remaining until redemption to those with a short time remaining. For other customers, it solicited switching from bonds with short remaining time to those with long remaining time.

Furthermore, Securities Company T, in the course of managing Family Fund investment trusts (see Note below), induced switching between funds with practically identical characteristics, due to insufficient understanding of such products or to a desire to improve sales results.

Note: Family Fund investment trusts

These funds consist of multiple unit-type investment trusts, which constitute Baby Funds, a large portion of which is jointly managed in the Mother Fund. Management efficiency can be expected, due to stability and large-lot holdings. Profits from management of the Mother Fund are allocated to the Baby Funds, which closely resemble each other in terms of investment effectiveness.

(d) Securities Company U, having decided to strengthen its sales organization for foreign bonds, commenced active marketing, stressing solid returns and other features in its sales presentations. However, the company executed a large number of same-day switching

transactions of foreign bonds with practically identical characteristics, such as currency and coupon rate. For customers with inadequate knowledge and experience and a desire for medium- or long-term investments, such switching transactions created superfluous currency exchange and other costs, making such investments less lucrative. Due to its inadequate knowledge of the benefits of such transactions, Securities Company U solicited switching transactions without sufficient explanation to customers.

(e) In an effort to raise commission income on stock transactions, the Stock Division of Securities Company V, from August 1993 to April 1995, decided which issues to recommend and sales volume goals, then allotted sales targets to each branch and commenced purchase solicitation to customers. The company particularly emphasized the future potential of four multimedia issues and recommended medium- and long-term investments. In order to reach the Stock Division's sales targets, however, Securities Company V solicited short-term loss-cutting switching and revolving transactions of identical issues to certain customers.

② In transactions between customers and securities companies to realize unrealized gains,

adjusting the losses and gains of securities companies resulting from said transactions through other transactions with the same customer.

Securities Company W received a request from a corporate customer for transactions to realize unrealized gains on three issues, which were executed on the stock exchange (sale by the customer to Securities Company W). The following day, however, the opening price of one of the issues fell below the previous day's selling price, leading to an expected loss for Securities Company W.

As a result, for the other two issues Securities Company W executed return transactions (sale by Securities Company W to the customer) at prices different from market prices and higher than those of the original transactions, making adjustments to ensure that trading in the three said issues did not incur losses for Securities Company W.

③ Inappropriate stock index futures transactions.

Securities Company X was entrusted by an institutional customer to execute spread transactions for stock index futures, with the aim of maximizing the profitability of Nikkei 225 and TOPIX transactions or achieving a

certain price differential by conducting two transactions in the same market over the one-month limit. After placing orders for both transactions on the market, one order was executed, but in the event that the other could not be executed, Securities Company X transferred the executed order to its own account. In conducting these transactions, Securities Company X assumed the price fluctuation risk of the order, illustrating a problem concerning the fairness of the transactions.

④ Inappropriate handling of stock transaction orders from investment advisory companies.

Securities Company Y commenced stock transactions on behalf of three customers introduced by an investment advisory company, but the orders were placed without indication by the investment advisory company in the customers' names. The said transactions continued despite evidence that the investment advisory company had not received contractual permission to make investment decisions. At the time of auditing of the SRO, the responses given were contrary to the facts.

(3) Internal control systems

① Problems related to insufficient internal control systems.

(a) Securities Company Z decided to adopt the computerized Attention System to examine its sales systems, and division and branch managers held interviews with customers to assure compliance with certain standards. However, the financial products being checked were stocks, warrants, futures and options, which are generally targeted at large-scale customers of stock transactions. The Attention System is not equipped to cover small-lot products, such as foreign bonds and investment trusts, which were primarily being marketed by Securities Company Z. As a result, the checking system was inadequate for the company's customers.

Note: Attention System

At securities companies, numerous sales representatives solicit numerous customers on a daily basis to undertake trading and other transactions, and determining the appropriateness of such solicitation activities is fundamentally under the control of individual sales offices. To support these efforts, the head office control divisions have set up external supervision systems to monitor transaction frequency, profit-loss status and other aspects related to customers. If a customer does not meet the standards, a hearing is held with

the sales representative (or an interview held with the customer if required) in order to prevent in advance the solicitation of inappropriate investments. These systems have several names, including Attention System and Alarm System, and have recently been computerized and are increasingly being adopted even by small and medium-sized securities companies.

(b) Securities Company A' decided to deploy the Attention System to improve the content of its transactions. This entailed determining the customers who generate high commissions, those who generate large losses on margin transactions, and others. The company conducted interviews with customers who did not fully understand the status of solicitation activities. However, the interviews were held in a perfunctory manner, and the status of the customers' will and solicitation activities was not sufficiently comprehended. Alternatively, problems may have been understood, but accurate guidance to ensure transaction improvement was not provided. As a result, the Attention System was not deployed in an effective fashion.

② Insufficient compliance with rules by securities company directors.

(a) Due to lack of understanding of securities-related mishaps at Securities Company B', the related divisions and departments were not contacted or properly informed. As a result, although it became known that transactions using borrowed names were being conducted due to complaints from customers, the handling of such mishaps was not sufficient. In addition, inappropriate handling of a problem related to mistaken solicitation of investment trusts was acknowledged.

(b) At Securities Company C', rules as determined by the SRO are reported to the sales branches. Due to insufficient understanding of rules determined by the head office control divisions, however, the sales branches did not receive adequate guidance. This led to insufficient understanding related to appropriate handling of securities-related mishaps, and to admission by branch managers that sales representatives had committed legal violations.

(c) Due to minimal awareness about compliance with laws and regulations among sales representatives, trade execution managers, sales control personnel and others at Securities Company D'—or due to insufficient checks by the control divisions—numerous instances

of legal violations went unnoticed. These included conducting own-account trading of Finance Issues during the stabilization period.

V. Results of Inspections of Financial Institutions Licensed to Provide Securities Services

As with securities companies, financial institutions were inspected for compliance with transaction rules and other important matters. Following is an example of problems acknowledged during the year under review:

Purchase and selling of bonds at prices exceeding the margin limit

(Violation of JSFA Fair Business Practice Regulations No. 3, covering regulations concerning the publication of OTC quotation of bonds, etc., and trading prices,

Article 14)

Due to insufficient understanding concerning bond transactions, Financial Institution A on numerous occasions conducted transactions of small-lot (less than ¥10 million) medium-term government bonds at prices exceeding the margin limit. Although this was pointed out by a business group, there was a delay in sending instructions to sales branches and in improving the relevant systems. As a result, violations continued even after the matter was pointed out.

VI. Results of Inspections of Financial Futures Dealers

During securities inspections, no problems were found regarding sales practices, including solicitation methods, or compliance with market rules.