

## **I. Relationship between the SESC and SROs**

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SROs (such as securities dealers associations, stock exchanges, financial futures dealers associations and financial futures exchanges) conduct surveillance activities of their members and make self-regulatory rules to ensure the fairness and transparency of the market. These activities determine whether member companies operate appropriately according to laws, regulations and self-regulatory rules. In this manner, the SROs operate closely with the SESC.

Nevertheless, the SESC assumes the right to examine the activities of SROs to determine whether surveillance is conducted appropriately and whether SROs are imposing strict sanctions against members who violate laws, regulations and self-regulatory rules.

With mediators as members, SROs establish frameworks for acceptable behavior and demand compliance with regulations, and are thus in a position to gain the respect of market participants. Through their efforts, SROs bring greater benefits to their mediators over the long term. In the current climate of relaxation of regulations, the role of SROs as enforcers of the law will become more and more important, and they will be expected to step up their efforts accordingly.

The SESC maintains close interactive relationships with SROs, with which it holds hearings on such

matters as the state of surveillance.

Following are activities during fiscal 1996 (April 1, 1996, to March 31, 1997) reported by SROs.

## **II. Activities of the Japan Securities**

### **Dealers Association**

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The activities of the JSDA during fiscal 1996 were as follows:

#### *1. Status of surveillance of association members*

##### *(1) Main surveillance items*

Items of surveillance of members (see Note 1 below) include the following: (1) observation of “principles of suitability” (see Note 2 below); (2) observation of regulations related to prohibited acts through securities transactions; (3) management of securities transactions; and (4) management related to clearing and settlement of cash and securities.

##### *Note 1: Members*

*There are two types of members, with differing authority and duties, as follows:*

*(1) Regular members (domestic and foreign securities companies); and*

*(2) Special members (financial institutions licensed to provide securities services).*

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*Note 2: Principles of suitability*

*"Principles of suitability," based on the premise that there are many cases in which securities companies have significant influence over customers' investment decisions, call for securities companies to give advice based on the investors' actual circumstances, and for securities companies to actively undertake appropriate screening to determine investment objectives, financial status and other circumstances related to customers.*

**(2) Conduct of surveillance**

In fiscal 1996, surveillance was conducted on 92 companies: 75 domestic and 17 foreign securities companies.

**(3) Summary of results**

Surveillance conducted in fiscal 1996 revealed a number of violations of laws and regulations, including (1) disregard for "principles of suitability," such as failure to prepare customer information cards and omission of necessary items on those cards, and failure to supply confirmation statements transactions; (2) disregard for regulations related to prohibited acts during securities

transactions, such as lending money to and borrowing money from customers, borrowing of account names and addresses by sales representatives, and conducting of sales activities by unlicensed persons; and (3) problems related to management of securities transactions, such as preparation of tender documents under assumed names, failure to collect moneys for purchase of securities, failure to prepare order forms for futures transactions, and failure to deliver securities depository receipts.

Apart from the above, there were no particular instances of legal violations, but several cases of violations of internal regulations were acknowledged, including customer management problems related to orders and the collection of deposits for securities purchases and the trading of securities by member directors.

In fiscal 1996, improvement was deemed particularly necessary in 19 cases, and the JSDA requested that these 19 members report on improvements in the situation and provided other necessary guidance. (Such requests were made to 17 companies in fiscal 1995.)

**Table 5: Inspections by the JSDA**

**(1) Regular Members**

(Unit: companies)

<b>Classification</b>	<b>Fiscal 1992</b> April 1, '92 to March 31, '93	<b>Fiscal 1993</b> April 1, '93 to March 31, '94	<b>Fiscal 1994</b> April 1, '94 to March 31, '95	<b>Fiscal 1995</b> April 1, '95 to March 31, '96	<b>Fiscal 1996</b> April 1, '96 to March 31, '97
Domestic securities companies	109	105	110	76	75
Foreign securities companies	21	25	20	14	17
Total	130	130	130	90	92

**(2) Special Members**

(Unit: companies)

<b>Classification</b>	<b>Fiscal 1994</b> April 1, '94 to March 31, '95	<b>Fiscal 1995</b> April 1, '95 to March 31, '96	<b>Fiscal 1996</b> April 1, '96 to March 31, '97
City Banks	2	9	9
Regional Banks	3	21	21
Regional Banks II	4	22	22
Shinkin Banks	2	14	14
Life Insurance Companies	2	6	6
Non-Life Insurance Companies	1	7	7
Others	1	2	2
Total	15	81	81

Note: "City Banks" refers to city banks, long-term credit banks, trust banks and government financial institutions. "Shinkin Banks" includes shinkin banks and The Zenshinren Bank, and "Others" includes call loan and discount companies and foreign banks.

## *2. Status of surveillance of special members*

### *(1) Main surveillance items*

Items of surveillance of special members include the following: (1) management of securities transaction orders; (2) compliance with rules related to prohibited acts through securities transactions; (3) management of the execution and clearing of securities transaction orders and custody of securities; and (4) management related to the processing of securities transactions.

### *(2) Conduct of surveillance*

Surveillance of special members is primarily delegated by the JSDA to the associations regularly organized by said special members (six in total), such as the Federation of Bankers Association of Japan. The associations implement surveillance with personnel designated by the JSDA. In fiscal 1996, surveillance was conducted on 81 financial institutions (53 banks, 14 *shinkin* banks, 13 insurance companies and one call loan and discount company).

This surveillance revealed violations of regulations by one member. The JSDA pointed out the violations to the member and requested that measures be taken to avoid repeat of such violations.

## *3. Conducting securities market surveillance*

### *(1) Summary of surveillance*

It is the duty of the JSDA's OTC Stock Watching Division (called the OTC Stock Watching Department until March 1997), which is responsible for investigation of securities transactions, to collect market information related to stocks registered over-the-counter and monitor stock prices and trading volume, as well as to collect information on members' participation in transactions. The Division conducts investigations when it observes irregularities in securities transactions. In addition, when the OTC Market Section (called the OTC Stock Market Section until March 1997) of the Securities Business Department reports on incidents having a considerable influence on investors' judgments, such as legal violations and the management, business and asset circumstances of OTC-registered companies, the former Division conducts detailed surveillance when necessary.

The Department maintains close relationships with these departments in the area of market surveillance. After the Department obtains results of initial surveillance, if necessary it requests that the Member Firm Inspection Department conduct further investigation.

## *(2) Surveillance results*

Surveillance was conducted in fiscal 1996 as follows:

Issues surveyed (selected because they fall under specific criteria):	2,369 issues
Market manipulation	1,409 issues
Issues surveyed (selected because they fall under specific criteria):	2,638 issues
Market manipulation	1,663 issues
Insider trading	966 issues
Others	9 issues
Issues investigated (requiring more detailed investigation based on results of above surveillance):	74 issues
Market manipulation	13 issues
Insider trading	52 issues
Others	9 issues

In addition to the surveillance activities described above, the office monitored real-time price movements to prevent other inappropriate acts from occurring.

## *(3) Summary of surveillance results*

When inappropriate securities transactions are uncovered through surveillance, according to its Articles of Association the JSDA takes disciplinary measures against the members involved to prevent such incidents from recurring.

In addition, when securities transactions are suspected, but not proven, to be inappropriate, the JSDA cautions the members involved to prevent such incidents from recurring. The JSDA also provides necessary directions for the acceptance and execution of orders to ensure fairness in over-the-counter price formation.

**Table 6: Market Surveillance by the JSDA**

(Unit: issues)

Classification	Fiscal 1992 April 1, '92 to March 31, '93		Fiscal 1993 April 1, '93 to March 31, '94		Fiscal 1994 April 1, '94 to March 31, '95		Fiscal 1995 April 1, '95 to March 31, '96		Fiscal 1996 April 1, '96 to March 31, '97	
	Surveillance		Surveillance		Surveillance		Surveillance		Surveillance	
		Investigation		Investigation		Investigation		Investigation		Investigation
Market manipulation	445	2	858	21	1,292	14	1,409	20	1,663	13
Insider trading	654	12	917	18	745	25	958	18	966	52
Others	15	15	7	2	14	9	2	2	9	9
Total	1,114	29	1,782	41	2,051	48	2,369	40	2,638	74

Note: "Investigation" indicates issues surveyed that required more detailed surveillance.

#### 4. Summary of penalization of association members

Disciplinary actions that the JSDA can take with the resolution of its Board of Directors include reprimands, the imposing of negligence penalties up to ¥100 million, the suspension or restriction of membership for a period not to exceed six months, or the revocation of membership.

During fiscal 1996, one reprimand and one penalty, totaling ¥1 million, were given according to Article 25 of the JSDA Articles. This penalty was imposed in conjunction with disciplinary actions based on SESC inspections.

### III. Activities of Stock Exchanges

Following are the activities of stock exchanges in fiscal 1996:

#### 1. Status of inspections

##### (1) Main inspection items

Items of inspection of stock exchange members and special participants (see Note below) are generally classified as follows:

- ① Compliance with regulations related to margin transactions and futures and options transactions;
- ② Administration of customer accounts;

③ Compliance with regulations related to commissions; and

④ Compliance with other rules, regulations and “principles of suitability.”

*Note: Special participants*

*“Special participants” refers to financial institutions other than members that are certified to participate directly in financial futures transactions on stocks and bonds listed on securities exchanges.*

## (2) Conduct of inspections

In fiscal 1996, inspections were made of 50 companies on the Tokyo Stock Exchange (TSE) (38 domestic securities companies, seven foreign securities companies and five special participant companies) and 23 domestic securities companies on the Osaka Securities Exchange (OSE).

**Table 7: Inspections by Stock Exchanges**

(Unit: companies)

Classification	TSE				
	Fiscal 1992	Fiscal 1993	Fiscal 1994	Fiscal 1995	Fiscal 1996
Domestic securities companies	49	55	46	24	38
Foreign securities companies	13	11	13	8	7
Special participant companies	4	6	6	4	5
Total	66	72	65	36	50

  

Classification	OSE				
	Fiscal 1992	Fiscal 1993	Fiscal 1994	Fiscal 1995	Fiscal 1996
Domestic securities companies	18	19	20	22	23
Foreign securities companies	—	—	—	—	—
Special participant companies	—	—	—	—	—
Total	18	19	20	22	23

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### *(3) Summary of inspection results*

The results of inspections carried out by the TSE and OSE in fiscal 1996 revealed a number of incidents, including (1) failure to observe regulations related to margin, futures and options transactions, including delays in collection of agreements to set up transaction accounts for margin and futures transactions, as well as shortages of and delays in making deposits for customers' margin; and (2) problems related to the administration of customers' accounts, including acknowledgment of advances of loss amounts for transaction settlements and advances of purchase amounts for margin transactions, and acknowledgment of confusion between customers' accounts for collateral securities and moneys, as well as violations of regulations and nonmarket trading of listed bonds that exceeded price-range limits.

According to the results of inspections, stock exchanges request their members and special participants to submit reports and provide directions as

necessary for the improvement of operational disposition (in fiscal 1996, directions were provided to six companies for insufficient internal control systems related to advances for TSE transactions, and to three companies for inappropriate customer approval management procedures related to OSE transactions).

## *2. Conducting securities market surveillance*

### *(1) Summary of surveillance*

Taking the TSE as an example, the Department of Market Surveillance and Compliance conducts investigations and surveys of issues selected by examining collected market information, issues notified by the Stock Market Department and Bond Market Department as abnormal in their trading, and issues reported by the Office of Listings Supervision as discharging material information influencing investment decisions. Thus, the Department of Market Surveillance and Compliance works on market surveillance in close cooperation with these departments.



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## *(2) Conduct of surveillance*

The total numbers of issues investigated by the TSE in fiscal 1996 are as follows:

Issues surveyed:	2,317 issues
Market manipulation	305 issues
Insider trading	1,826 issues
Others	186 issues
Issues investigated (requiring more detailed investigation based on results of surveillance):	335 issues
Market manipulation	51 issues
Insider trading	118 issues
Others	166 issues

In addition, the Stock Market Department and the Bond Market Department also monitor real-time price movements to prevent inappropriate transaction-related activities from occurring in advance.

## *(3) Summary of surveillance results*

When inappropriate transactions are uncovered through investigations, stock exchanges impose sanctions against the members or special participants involved in view of preventing such transactions from recurring.

In addition, when securities transactions are suspected but not proven to be inappropriate, stock exchanges issue cautions to the members concerned in order to prevent unfair transactions from occurring.

Furthermore, stock exchanges provide necessary directions for the acceptance and execution of orders that will ensure fairness in price formation.

**Table 8: Market Surveillance by the TSE**

(Unit: issues)

Classification	Fiscal 1992 April 1, '92 to March 31, '93		Fiscal 1993 April 1, '93 to March 31, '94		Fiscal 1994 April 1, '94 to March 31, '95		Fiscal 1995 April 1, '95 to March 31, '96		Fiscal 1996 April 1, '96 to March 31, '97	
	Surveillance		Surveillance		Surveillance		Surveillance		Surveillance	
		Investigation		Investigation		Investigation		Investigation		Investigation
Market manipulation	834	114	265	133	138	57	115	41	305	51
Insider trading	1,690	52	1,767	64	1,625	63	1,707	88	1,826	118
Others	19	5	72	29	46	6	120	63	186	166
Total	2,543	171	2,104	226	1,809	126	1,942	192	2,317	335

Note: "Investigation" indicates issues surveyed that required more detailed surveillance.

**Table 9: Market Surveillance by the OSE**

(Unit: issues)

Classification	Fiscal 1995 April 1, '95 to March 31, '96		Fiscal 1996 April 1, '96 to March 31, '97	
	Surveillance		Surveillance	
		Investigation		Investigation
Market manipulation	269	29	211	30
Insider trading	135	44	226	7
Others	0	0	14	0
Total	404	73	451	37

Note: "Investigation" indicates issues surveyed that required more detailed surveillance.

### **3. Summary of sanctions against members**

Pursuant to Article 50 of the TSE Charter, if the stock exchange deems that a member or special participant has violated laws, regulations, its charter, or just and equitable principles of trade, the exchange may, after providing the opportunity for a hearing from the member, impose sanctions such as negligence penalties of up to ¥100 million; censure; suspension from or restriction on transactions in the market of the exchange; suspension of membership for up to six months; and revocation of membership (suspension or cancellation of license to conduct transactions, in the case of special participants).

Pursuant to Article 55 of the TSE Charter, if a member or special participant undergoes disciplinary actions, such as business suspension, business restriction or license revocation, based on the extent of the above disciplinary actions, the exchange shall suspend or restrict said member's transactions in the market of the exchange or revoke exchange membership.

In fiscal 1996, sanctions by the TSE under Article 50 of its charter included one negligence penalty, totaling ¥1 million, and under Article 55, one case in which limitations on securities transactions were imposed. In addition, under Article 55 of its charter, the OSE imposed sanctions in one case. These disciplinary

actions were carried out in conjunction with inspections conducted by the SESC.

## **IV. Activities of the Financial Futures Dealers Association of Japan**

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Following are the surveillance activities of the Financial Futures Dealers Association of Japan in fiscal 1996:

### **(1) Main surveillance items**

Items of surveillance of association members include management of financial futures transaction orders, management of customers' margin, and compliance with rules concerning regulating financial futures transactions.

### **(2) Conduct of surveillance**

In fiscal 1996, surveillance activities were carried out on 19 member companies (seven banks, six securities companies and six companies in the call loan and discount and other business fields).

### **(3) Summary of surveillance results**

The following incidents were discovered during surveillance activities in fiscal 1996: insufficient management of agreements to set up transaction accounts;

omission of necessary items on customer management cards and order forms; and omission of necessary items on reports of operating results. The association advised

the members involved to correct these points.

**Table 10: Market Surveillance by the Financial Futures Dealers Association of Japan**

(Unit: companies)

<b>Category</b>	<b>Fiscal 1992</b> April 1, '92 to March 31, '93	<b>Fiscal 1993</b> April 1, '93 to March 31, '94	<b>Fiscal 1994</b> April 1, '94 to March 31, '95	<b>Fiscal 1995</b> April 1, '95 to March 31, '96	<b>Fiscal 1996</b> April 1, '96 to March 31, '97
Banks	—	6	8	9	6
Securities companies	—	3	7	7	6
Call loan and discount companies	1	2	2	1	3
Others	—	2	1	1	4
<b>Total</b>	<b>1</b>	<b>13</b>	<b>18</b>	<b>18</b>	<b>19</b>

Notes: 1. "Call loan and discount companies" refers to call loan and discount companies and foreign exchange brokers.  
2. "Others" indicates futures companies and *shinkin* banks.

## V. Activities of the Tokyo International Financial Futures Exchange

Following are the activities of the Tokyo International Financial Futures Exchange in fiscal 1996:

### 1. Inspection results

#### (1) Main inspection items

Items of inspection of exchange members include management of financial futures transaction orders, compliance with rules related to prohibited acts during

financial futures transactions, and management of internal control systems.

### (2) Conduct of inspections

In fiscal 1996, inspections were carried out on 17 member companies (seven banks, eight securities companies and two companies in the call loan and discount and other business fields).

### (3) Summary of inspection results

Following inspections carried out in fiscal 1996, the

Exchange sent directives to rectify a number of problems, including omission on necessary legal book-keeping items on order forms and on agreements to set up transaction accounts; and lack of distinction between own account and customer orders.

### 2. Activities of the Surveillance Section

Regarding transaction surveillance, because all transactions are systematized, surveillance software has been specially developed to regularly monitor transactions. As required, hearings are also held for members.

**Table 11: Market Surveillance by the Tokyo International Financial Futures Exchange**

(Unit: companies)

Category	Fiscal 1994 April 1, '94 to March 31, '95	Fiscal 1995 April 1, '95 to March 31, '96	Fiscal 1996 April 1, '96 to March 31, '97
Banks	1	6	7
Securities companies	—	2	8
Call loan and discount companies	—	1	2
Others	—	2	0
Total	1	11	17

Notes: 1. "Call loan and discount companies" refers to call loan and discount companies and foreign exchange brokers.  
2. "Others" indicates futures companies and *shinkin* banks.