

(10) Iseki Poly-Tech Case (Insider Trading)

A board director of Iseki Poly-Tech Inc. gained knowledge of a decision by the company to file for court protection from creditors under the Civil Rehabilitation Law before the company announced the decision. The director conspired with two other suspects and sold shares of Iseki Poly-Tech under the name of a company in which one of the suspects sat as a board member before the announcement of the plan in an attempt to avoid capital losses that might arise from holding the shares.

2. Inspections

1) Outline

1. Inspections to ensure fair trading

(1) Objectives and scope of SESC inspections

The SESC conducts on-site inspections of securities companies and other entities to check their compliance with laws and regulations for ensuring fairness in securities transactions. The inspections are conducted under the authority delegated to the SESC by the Prime Minister and the FSA Commissioner, as prescribed under the SEL, LFSF and FFTL.

(2) Scope of Inspections

The scope of inspections is prescribed under cabinet orders (Article 38 of the SEL Enforcement Order, Article 20 of the LFSF Enforcement Order and Article 9 of the FFTL Enforcement Order). Subject to inspection are acts by securities companies, their executives or other employees that are prohibited in (for example, securities trading meant to create an artificial market that does not reflect the actual state of the market, false statements about securities trading, misleading statements about important investment factors and the act of soliciting business with promises to provide special benefits) and other violations of securities laws and regulations, including the guaranteeing of the repayment of investment losses, reimbursement of investment losses, price manipulation and insider trading.

2. Inspections with respect to verifying traders' identity

(1) Objectives and scope of SESC inspections

Under the authority entrusted by the Prime Minister and the FSA Commissioner based on the Personal Identity Verification Law, the SESC conducts on-site inspections of securities companies and related entities to check if these companies are taking adequate measures to verify their customers' identity and maintain their transaction records.

The inspections are mainly aimed to encourage securities companies to improve their customer management system.

(2) Scope of inspections

Based on the authority to inspect securities companies and order to produce documents, which is prescribed under the Personal Identity Verification Law (PIVL), the SESC conducts inspections of securities companies to check if they have verified the identity of a customer (Article 3 of the PIVL) when there is suspicion that the customer is receiving securities brokerage services from the securities companies by pretending to be other person whose name is registered for the transaction or that the customer is

falsifying his or her name, address and date of birth (in the case of a corporate entity, the corporate name and location of the head office and main offices). Under such circumstances, the SESC also conducts inspections of the securities companies to check if they have prepared documents after the verification and have kept these documents (Article 4 of the PIVL).

2) Basic inspection policy

Inspections are planned and executed on a one-year cycle. Each SESC year begins on July 1 and ends on June 30 of the following year.

At the beginning of each SESC year, the SESC established a basic inspection policy and a basic inspection plan of the year to ensure that inspections conducted by the SESC and local Finance Bureau chiefs are managed and implemented smoothly and efficiently.

The basic policy determines priority items and other basic matters for inspections for the new year, while the basic plan specifies the number and types of companies which will become subject to inspections for the year from among domestic brokerage houses, foreign securities houses and other financial institutions registered for securities business.

3) Results of inspections

1. Outline of conducted inspections

In the 2003 SESC year, the SESC and Local Finance Bureaus carried out inspections of 107 domestic securities companies, 17 foreign securities companies, 13 financial institutions registered for securities business, one financial futures trader and two self-regulatory organizations. These inspections included a total of 25 special inspections, up significantly from five in the previous year. The uptrend of such inspections reflected the SESC's moves to flexibly deal with new developments in the securities market while maintaining the basic policy of conducting regular inspections in line with inspection plans. Among the special inspections launched under such circumstances during the year were those using the results of analysis made by the SESC's Market Surveillance Office, which is in charge of the day-to-day oversight of securities deals, and those focusing on particular areas or topics reflecting new moves and developments in the securities industry.

2. Inspections of interest-conflicting acts in connection with analysts' reports

In its basic inspection policy for the 2003 SESC year, the SESC listed the inspection of interest-conflicting acts in connection with analysts' reports as a major issue to be tackled by the SESC in view of the need to increase investor protection and the fairness and transparency of markets. The following irregularities were reported when the SESC, based on that policy, inspected interest-conflicting conducts of securities companies in relation to analysts' reports prepared by their research departments to be distributed to general investors.

(1) Act of making misleading statements about important matters (violation of Article 4, item 1 of the Ordinance of Cabinet Office Concerning Regulation, etc. of Conducts of Securities Company, based on Article 42, Paragraph 1, item 9 of the SEL)

A securities company asked an information-providing firm to prepare analysts' reports based on their agreement in which the securities company was to select particular stocks to be dealt with in the reports and pay money for the firm's compilation of the reports. However, the reports did not refer to any agreement between the securities company and the information-providing firm on the selection of the stocks to be analyzed and the compensation for it, and the overall manner with which the stocks were analyzed in the reports left the impression that the information-providing firm selected

the stocks on its own judgment from among a host of stocks slated for public offering.

(2) Securities trading by an employee of a securities company based on information he obtained through business (violation of Article 4, item 5 of the Ordinance of Cabinet Office Concerning Regulation, etc. of Conducts of Securities Company, based on Article 42, Paragraph 1, item 9 of the SEL)

When engaging in their assigned daily business operations, an employee of a securities company had the opportunity to look into the yet-to-be-released analysts' report on a particular listed stock that included recommendation for investors to buy the stock. Knowing that a large number of general investors would go for the stock after the release of the report, the employee bought shares of the listed company on their own accounts based on the recommendation in the report before their release.

(3) Failure by a securities company to take sufficient steps to prevent unfair trading in connection with handling of undisclosed corporate-related information (violation of Article 10, item 4 of the Ordinance of Cabinet Office Concerning Regulation, etc. of Conducts of Securities Company, based on Article 42, item 2 of the SEL)

Due to a failure by a securities company to take adequate steps over the control of undisclosed corporate-related information, the analyst of the securities company's stock research departments listed information on a particular listed firm it had obtained from the firm on its analyst report with no knowledge that such information was classified as undisclosed corporate-related information, as defined under the SEL.

The other division in charge of screening analysts' reports also overlooked the inclusion of such corporate-related information in the reports, and consequently the reports were posted on the securities company's Web site. The screening division then explained the reports at in-house meetings and distributed the reports to a large number of client investors via e-mail. The situation indicated that the securities company was operating their businesses even though they failed to take sufficient steps to prevent unfair trading in connection with handling of undisclosed corporate-related information.

(4) Failure by a securities company to adequately manage analysts' reports and securities analysts

A securities company concluded a contract with a securities analyst not employed by the company for the compilation of analysts' reports. In reports compiled based on the contract, the analyst newly assigned good ratings to the stocks of particular companies. The analyst then repeatedly bought the stocks of these companies before the release of the reports and repeatedly sold the stocks after the release of the reports. The situation indicated that the securities company failed to take sufficient measures to control the compilation of analysts' reports and the activities of securities analysts.

(5) Failure by a securities company to establish systems to adequately screen and manage analysts' reports

A securities company did not have systems established for officials in charge of screening analysts' reports to adequately check if the reports contained erroneous information, and had not taken sufficient measures for that purpose. In addition, the securities company did not have systems established that would enable all clients to easily recognize revisions to analysts' reports when the reports were revised after the initial release of the reports.

(6) Prior notification of the summary of analysts' reports to companies covered in the reports before their release

A securities company sent excerpts of analysts' reports, which excluded information on three items-ratings, targeted stock prices and investment highlights-to companies covered in the reports before the reports' formal release in order to check if the reports contained erroneous information on these companies. However, the reports were sent to the covered companies although information provided did not undergo in-house screening and contained the analysts' personal views on the covered companies.

(Reference) The conduct mentioned above is prohibited under "handling of analysts' reports by securities companies," a resolution approved by the board of directors of the Japan Securities Dealers Association, which states that member securities companies are banned from informing companies covered in analysts' reports of their content before the release of the reports (Article 13. Ban on prior notification to companies covered in analysts' reports).

Based on problems related to analysts' reports, unearthed by the SESC's inspections as explained in (1) and (4), the SESC made a policy proposal to the FSA Commissioner on December 16, 2003 that the FSA take necessary measures to ensure fairness in securities trading.

3. Outline of securities company inspection results

The SESC completed inspections of 130 companies in the 2003 SESC year, including those whose inspections were carried over from the previous year. Of the 130 firms, problems were found at 67 companies. (The 67 companies accounted for 52% of the total.) Violations of market rules and regulations were detected at 43 companies. Other problems found many concerned how business was solicited from customers and the in-house management of business operations. In the reporting year, violations of so-called "Suitability Rule", which is prescribed under Article 43, item 1 of the SEL, were detected for the first time since this provision was enforced in 1992. Securities companies generally rectified problems found in the previous inspections, but some of them were found to have the same problems as detected in the previous inspections. In particular, several securities companies were still engaged in discretionary-account trading in violation of the SEL even though it had been pointed out in the past inspections. Of those, one securities company repeated the illegal trading practice in the reporting year by not taking adequate steps to rectify the situation even though it was blamed on the same matter in the past inspection. The SESC recommended to the Prime Minister and the Commissioner of FSA that it takes administrative disciplinary action against the company, judging that the company should be at fault over the insufficient management and supervision of employees' trading activities.

(Reference: Problems were found at 58% of the inspected companies in the 2002 SESC year, 63% in the 2001 SESC year and 64% in the 2000 SESC year.)

4. Outline of registered financial institution inspection results

Inspections of financial institutions registered for securities business concerned areas that were basically the same as those for securities companies, including compliance with market rules, how investments were solicited from customers and the in-house management of business operations. The inspections showed some registered financial institutions had problems as shown below.

- (1) When some financial institutions made clerical errors in executing orders placed by customers for investment trusts, they did not explain to the customers the fact that it was still possible to nullify the erroneously executed orders and execute the same

- orders from the beginning. Instead, they tried to settle the issue by seeking the customers' approval on what they had already done while offering an apology.
- (2) Some financial institutions showed ads containing the content of specific investment trust products to many customers as a way to solicit business from them even though the ads did not undergo checks by in-house officials in charge of screening such ads.

5. Outline of financial futures trader inspection results

In the 2003 SESC year, the Kanto Local Finance Bureau conducted an inspection on a firm mainly engaging in financial futures trading and found problems with its trading as explained below. In June 2004, the bureau chief notifies the firm of the inspection results, and the SESC made a recommendation to the Prime Minister and the FSA Commissioner.

- (1) Business solicitation accompanied by pledges to generate profit, conclusion of contracts for discretionary-account trading, reimbursement of investment losses and the act of providing benefits to customers to increase their fortune
- (2) Conduct that is recognized as significantly inappropriate for financial futures trading

In the 2003 SESC year, the SESC conducted inspections of firms which were authorized to conduct financial futures trading business to check if they were complying with market rules and how they were soliciting business from customers. However, no problems with financial futures trading by them were found in the inspections.

6. Outline of self-regulatory organization inspection results

The SESC conducts inspections of self-regulatory organizations, jointly with the Inspection Bureau of the FSA as a general rule, to make a comprehensive examination of operations of securities exchanges and their financial conditions amid increasing moves by securities exchanges to become stock companies and an increase in roles to be played by the exchanges as self-regulatory organizations.

The SESC launched inspections of trading at the Osaka Securities Exchange (OSE) in May 2002 and informed the OSE of the results in August 2003. In addition, the SESC conducted special inspections of the OSE in February 2004, and later informed the OSE of the results.

In May 2004, the SESC conducted inspections of the Nagoya Stock Exchange (NSE) and informed the NSE of the results in July 2004.

3. Recommendations

1) Outline

Based on the results of the inspections or the investigations of criminal offenses, the SESC may, if deemed necessary, present recommendations to the Prime Minister and the FSA Commissioner on administrative disciplinary actions and other necessary measures intended to ensure fairness in securities transactions (Article 20, Paragraph 1 of the FSA Establishment Law).

Specifically, recommendations by the SESC include proposing that administrative disciplinary measures be taken against securities companies and other entities if they are found to be violating laws and proposing that self-regulatory organizations take punitive measures against executives or employees of securities companies for such violation.

The SESC can ask the Prime Minister and the FSA Commissioner for a report on the measures taken based on the SESC's recommendations (Article 20, Paragraph 2 of the FSA Establishment Law).