

# Annual Report 2016/2017

**Securities and Exchange Surveillance Commission**





## **Introduction**

The Securities and Exchange Surveillance Commission (SESC) is a consultative body consisting of a Chairman and two Commissioners and the Executive Bureau incorporated in the Financial Services Agency (FSA). Its mission is to ensure the fairness and transparency of markets, protect investors, contribute to the sound development of capital markets and support the sustainable economic growth.

This year, the SESC marks the 25th anniversary of its establishment in 1992. Since its establishment, the SESC has been authorized to investigate criminal cases with the aim of clarifying the truth behind any malicious market misconduct. Furthermore, during the 25 years from its establishment, the SESC has expanded and enhanced its authority through the introduction of the administrative monetary penalty system in 2005, and the expansion of its authority to inspect for funds, etc., in 2007, while its Executive Bureau has been expanded from two to six divisions. At the same time, the SESC has not only filed criminal charges against malicious violations but also contributed to improving the soundness of the markets by actively taking advantage of the authority to conduct inspections and investigations as well as the administrative monetary penalty system.

## **Key Achievements**

The environment surrounding markets is changing very rapidly, and to respond to problems that occur in the capital markets appropriately, we need to be versed in the background information of problems so that we can respond in an appropriate manner.

And, in response to the changing environment, we, the watchdog of the capital markets, are undergoing a major change. Last December, Chairman and both Commissioners were replaced, and this past January, we released "Strategy & Policy of the SESC 2017-2019," which will guide the SESC for the next three years. In this release, we set ourselves a new mission of preventing market abuse by deep-dive identification and analysis of root causes behind market misconduct, not just recommending imposition of an administrative monetary penalty or filing criminal charges against suspects.

New efforts started in FY2016 included the launch of the Office of Market Monitoring, which is tasked to conduct market monitoring in a forward-looking manner with a focus on domestic and overseas risk factors and changes in the market environment through analysis with a macro-economic approach. With respect to monitoring of Financial Instruments Business Operators, we introduced a new framework that integrates on-site and off-site monitoring into a seamless process.

As the number of recommendations to impose administrative monetary penalties for market misconduct made by SESC has been on the rise, we strived to fix and prevent recurrence of the problems at an early stage by conducting holistic analysis of the entire picture of the problems behind market misconduct quickly.

## **Future Challenges**

Even as events including the U.K.'s decision last year to exit from the European Union (Brexit) cloud the future of the global economy, cross-border transactions are growing as Japanese companies aggressively seek overseas expansion and the number of foreign investors increases in the Japanese markets. Furthermore, high-speed transactions such as HFT have increased, driven by developments in information technology. Under such circumstances, we are faced with the need to upgrade the system environment used for inspection and investigation, strengthen cooperation with relevant ministries and local government offices, and work more closely with self-regulatory organizations, industry bodies and overseas regulatory authorities so that we can conduct market monitoring in a forward-looking manner and respond to market abuse strictly and appropriately. We also feel it is important to engage in dialogue with relevant parties as a way to enhance market integrity.

This annual report outlines the SESC's activities in FY2016 and explains its views on issues brought to light in performing its duties in accordance with the provisions of Article 22 of the Act for Establishment of the Financial Services Agency (Act No. 130 of 1998). It is our sincere hope that it will be read by many market participants and investors so that their understanding of our activities is deepened, and that it will contribute to the creation of more fair and transparent markets.

August 2017

Mitsuhiro HASEGAWA  
Chairman  
Securities and Exchange Surveillance Commission



## 25 Years of SESC

Year	Changes in SESC's authority, organization	Key events, activities
1991		Series of securities/financial irregularities
1992	SESC established in Finance Ministry	
1993		<b>Filing of criminal charges:</b> Market manipulation related to Nihon Unisys, Ltd., shares (first instance of SESC filing criminal charges)
1998	Financial Supervisory Agency established; SESC comes under its jurisdiction	
2001	Financial Services Agency established; SESC comes under its jurisdiction	Major reorganization of central government agencies
2005	<b>Administrative monetary penalty system introduced</b> SESC mandated to exercise investigative authority SESC mandated to exercise inspection authority on disclosure statements Additional inspection authority given to SESC (inspection of financial soundness, inspection of investment advisors)	<b>Filing of criminal charges:</b> False entry in securities report related to Kanebo, Ltd.
2006	Five-division structure introduced (Coordination Division, Market Surveillance Division, Inspection Division, Civil Penalties Investigation and Disclosure Documents Inspection Division and Investigation Division) Additionally mandated to exercise authority on investigation of market manipulation using sham order transactions; authority to conduct criminal investigation expanded	<b>Filing of criminal charges:</b> Spreading of rumors, fraudulent means related to Livedoor Marketing Co., Ltd., shares <b>Filing of criminal charges:</b> Insider trading related to Nippon Broadcasting System, Inc. shares
2007	Additionally mandated to exercise authority on inspections of investment funds	Financial Instruments and Exchange Act in full effect
2008	Additionally mandated to exercise authority to conduct disclosure statements inspection on quarterly securities reports and internal control reports; additionally mandated to exercise authority to conduct investigation for potential imposition of administrative monetary penalties on violations in quarterly securities reports (1) Additionally mandated to exercise authority to conduct Disclosure Statements Inspection on false disclosure statements in Tender Offer Notifications, Reports of Possession of Large Volume (2) Additionally mandated to exercise authority to conduct investigation for potential imposition of administrative monetary penalties related to market manipulation by means of Fictitious or Collusive Sales and Purchases (3) Additionally mandated to exercise authority to file petitions for court injunctions against violations by unregistered business operators	
2010	Additionally mandated to exercise authority to inspect credit rating agencies	
2011	Additionally mandated to exercise authority to inspect group companies (consolidation regulation of large securities companies introduced) Six-division structure introduced (Coordination Division, Market Surveillance Division, Inspection Division, Administrative Monetary Penalty Division, Disclosure Statements Inspection Division and Investigation Division)	

	Office of Investigation for International Transactions and Related Issues set up	
2012	Additionally mandated to exercise authority to inspect trade repositories	<p>Filing of criminal charges, recommendation for administrative monetary penalty: False disclosure statements in Securities Report related to Olympus Corporation</p> <p>Recommendation for administrative disciplinary action, filing of criminal charges: AIJ Investment Advisors Co., Ltd. (false notifications, violation of duty of loyalty, etc.)</p>
2013	Additionally mandated to exercise authority to conduct disclosure statements inspections on external conspirators who allegedly assisted in submission of false disclosure documents and administrative monetary penalty investigations on market misconduct, and summon alleged violators as part of administrative monetary penalty investigations	Recommendation for administrative disciplinary action: MRI International, Inc. (diversion of investments, etc.)
2014	Anti-insider trading regulations introduced, SESC additionally mandated to exercise authority to conduct administrative monetary penalty investigations and criminal investigations against tipping and trade recommendation	
2015	Office of IT Forensics and Information set up	<p>Filing of criminal charges: Market manipulation, spreading of rumors, use of fraudulent means, failure to submit Reports of Possession of Large Volume related to New Japan Chemical Co., Ltd. shares</p> <p>Recommendation for administrative monetary penalty: False statements in Securities Report related to Toshiba Corporation</p>
2016	Office of Market Monitoring set up Litigation Office set up	Recommendation for administrative disciplinary action: Arts Securities Co., Ltd. (false notification, etc.)
2017		Filing of criminal charges: Use of fraudulent means by Arts Securities Co., Ltd., etc. (MARS)

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[Disclaimer: This is an unofficial translation and provided for reference only]



## Abbreviations

FSA Establishment Act	Act for Establishment of the Financial Services Agency (Act No. 130 of 1998)
FIEA	Financial Instruments and Exchange Act (Act No. 25 of 1948)
SEA	Securities and Exchange Act (Renamed the "Financial Instruments and Exchange Act" due to the Act for the Amendment of the Securities and Exchange Act, etc. (Act No. 65 of 2006))
Anti-Criminal Proceeds Act	Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007)
Investment Trust Act	Act on Investment Trusts and Investment Corporations (Act No. 198 of 1951)
SPC Act	Act on Securitization of Assets (Act No. 105 of 1998)
Act on Transfer of Bonds, etc.	Act on the Book-Entry Transfer of Company Bonds, Shares, etc. (Act No. 75 of 2001)
Order for Enforcement of the FIEA	Order for Enforcement of the Financial Instruments and Exchange Act (Cabinet Order No. 321 of 1965)
FIB Cabinet Office Ordinance	Cabinet Office Ordinance on Financial Instruments Business, etc. (Cabinet Office Ordinance No. 52 of 2007)
Ordinance on Security Deposits	Cabinet Office Ordinance on Transactions under Article 161-2 of the Financial Instruments and Exchange Act and Deposits Related Thereto (Ordinance of the Ministry of Finance No. 75 of 1953)



## Chapter 1. Summary of the SESC's activities

### 1. Overview of activities in Fiscal Year 2016

Various changes took place in FY2016 ended March 2017 in the domestic and global economic environment, affecting Japan's financial markets. Domestically, negative interest rates remained in place. Interest rates also remained low globally as monetary policy was eased. In the global economy, the decision by the United Kingdom to leave the European Union, known as Brexit, and China's debt issue increased uncertainty. On the other hand, listed companies in Japan have been actively expanding their business as evidenced by the increasing number of M&A both in Japan and abroad.

Given such circumstances, the SESC implemented market monitoring with a forward-looking perspective, focusing on risk factors and changes in the environment in Japan and abroad through analysis under a macro-economic approach. In performing its monitoring and investigation duties, the SESC not only made recommendations for administrative monetary penalties against violations of laws and regulations but also looked closely into the root causes to prevent recurrences.

### 2. Increase in recommendations for administrative monetary penalties and filing criminal charges against market misconduct

#### (1) Recommendation for administrative monetary penalties and filing criminal charges against market misconduct

There were 58 cases in which the SESC filed criminal charges or made recommendations of administrative monetary penalty payment order. In particular, the number of recommendations increased significantly to 51 cases in FY2016 from 35 in the previous year.

#### (2) Market oversight leading to recommendations and criminal charges

The number of market oversight examinations in which the SESC and the local finance bureaus conducted to identify signs of suspicious market misconduct or other potential infringement actions also increased to 1,142 in FY2016 compared to 1,097 in the previous year.

#### (3) Trends in market misconduct

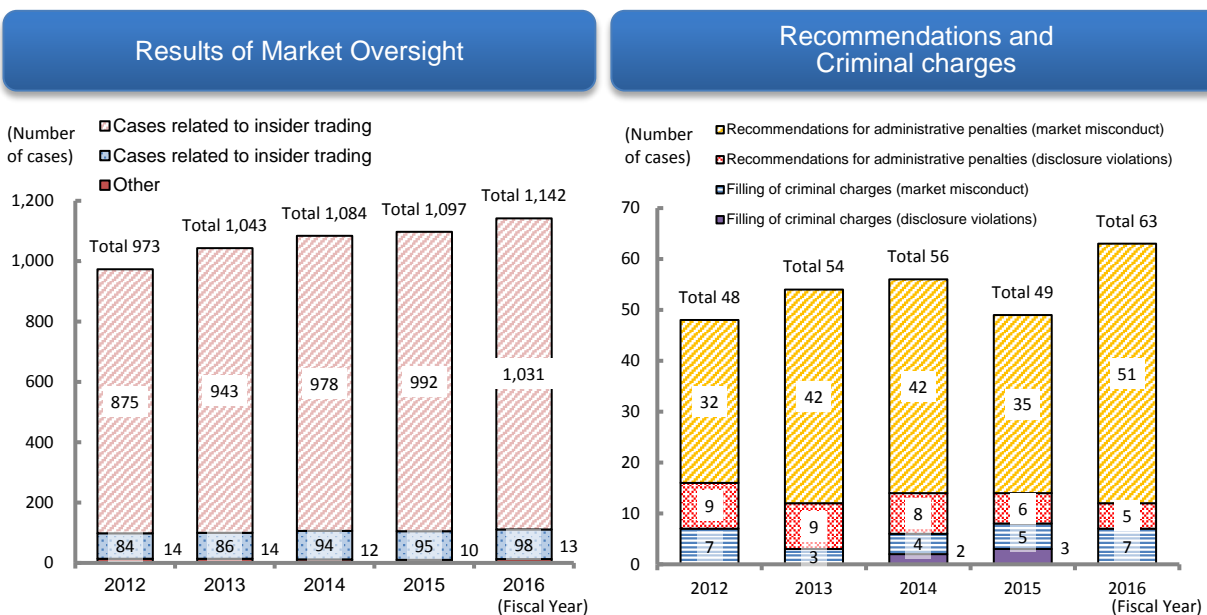
Insider trading cases have increased both in market surveillance and recommendations for administrative monetary penalties. In particular, amid moves to strengthen corporate governance and increased focus on return on equity, there was an increase in the number of insider-trading cases that involved such material facts as business alliances and takeover bids. There were also cases in which the material facts involved information on occurrences of data-falsification. The investigation of insider trading highlighted internal controls issues at many listed companies, such as insufficient knowledge and inadequate handling of material facts.

Methods for market manipulation have become more complicated and cunning. With advancement of information technology, there were cases which induced algorithmic trading orders from other investors or placed orders using accounts at multiple brokerages to avoid detection of market misconduct. Some cases involving cross-border transactions committed by traders located overseas can also be seen.

The SESC, going beyond just making a recommendation for administrative monetary penalties, filed criminal charges against a securities brokerage firm that was selling Medical Accounts Receivable Securitized bonds (MARS) for conducting fraudulent means, since the company's conduct was very malicious and exceeded the scope of recommendation for administrative monetary penalties.

#### (4) Policy going forward

Going forward the SESC will continue to improve its market-monitoring systems and review the method of investigation and inspection in order to catch up with the changing environment surrounding the market and ensure flexible implementation of investigation and inspection.



### 3. Disclosure violations highlight risks in corporate governance

#### (1) Recommendation against disclosure violations

There were still cases of companies in financial difficulties violating disclosure rules, with the SESC making recommendations regarding five such cases in FY2016.

#### (2) Trends in disclosure violations

The cases in which the SESC found disclosure-related problems had such root causes as governance malfunctions and inadequate awareness of compliance at the companies, and lack of intra-company communication.

Even among cases where there were no clear indication of disclosure violations, there were many in which listed companies were implicated in issues such as data or

account falsification and forced to set up a third-party committee to investigate the matter, raising concerns of potential risk in internal controls.

(3) Policy going forward

In order to address these risk factors, the SESC will carefully examine not only financial information on disclosure statements but also nonfinancial information, such as information related to corporate governance, and aim to deepen its analysis.

The SESC also aims to focus its efforts on finding and pointing out root causes and conduct continuous monitoring in a forward-looking manner with the ultimate goal of preventing occurrences and recurrences of violations.

#### 4. Shift from inspections to seamless on-site/off-site monitoring of Financial Instruments Business Operators, etc. (collectively, FIBOs)<sup>1</sup>

(1) Recommendations for administrative disciplinary actions and publication

The number of recommendations issued against FIBOs (excluding QII Business Operators) increased to 22 instances in FY2016 from 18 in the previous year.

An amendment to the Financial Instruments and Exchange Act (FIEA) that took effect in March 2016 enabled the Prime Minister to take administrative disciplinary actions against QII Business Operators, and the SESC made 13 recommendations against these operators in FY2016.

(Fiscal Year)		14	15	16
FIBOs (excluding QII Business Operators)	Number of recommendations	16	18	22
QII Business Operators, etc. (including Specially Permitted Investment Management Business Operators)	Number of recommendations	-	0	13
	Number of publications	17	17	23

- The “number of recommendations” is of cases in which the SESC recommended that the Prime Minister and the FSA Commissioner take administrative disciplinary actions in response to violations of laws and regulations detected during on-site monitoring.
- The “number of publications” is of cases in which the SESC made the on-site monitoring results public in response to violations of laws and regulations or problems concerning investor protection.
- The Specially Permitted Investment Management Business Operators (SPIMBOs) are those who operate businesses specified under Article 48(1) of the Supplementary Provisions of the Act to Partially Amend the Securities and Exchange Act (Act No. 65 of 2006).

<sup>1</sup> Any businesses that are subject to securities monitoring, including Financial Instruments Business Operators, registered financial institutions, financial instruments intermediary service providers, Qualified Institutional Investor Business Operators (“QII Business Operators”), credit rating agencies, and so on.

(2) Dew approach to monitoring

The SESC had historically focused mainly on reviewing an entity's control environment for legal/regulatory compliance and financial soundness, and it had typically conducted these reviews through on-site inspections. However, since July 2016, the SESC has been conducting seamless on-site/off-site monitoring and effective risk assessments on all FIBOs, while taking account of their business types, scale and other characteristics. In addition to monitoring individual FIBOs, the SESC has also reviewed the effectiveness of governance and internal audits, etc. at major securities firms across business sectors.

FIBOs subject to on-site monitoring were determined based on risks identified through off-site monitoring. In carrying out on-site monitoring of a FIBO, the SESC conducted in-depth analyses of the entity's products and transaction schemes to assess the appropriateness of its business operations. When these analyses identified a problem, the SESC went further to identify the root causes of the problem.

(3) Trends found in monitoring

The monitoring activities as described above shed light on many cases in which false representations or misleading representations about important matters were made ("misrepresentations") in solicitation for the sale of privately-placed bonds and interests in funds or the conclusion of investment advisory contracts. In addition to misrepresentations in solicitation documents, there were a number of cases in which a violator used a website that showed FIBOs in a ranking format to mislead the investors by making itself appear as a high-quality FIBO.

In recommendation cases, the management of many of the FIBOs lacked awareness of their obligation to comply with laws and regulations and protect investors.

(4) Policy going forward

The number of operators subject to monitoring by the SESC has increased to approximately 7,000 on a gross basis and these firms offer an increasingly diverse and complex set of services, products, and trading strategies. Amid such circumstances, the SESC aims to conduct more effective and efficient on-site monitoring based on risks identified through off-site monitoring, and strive to improve its system for conducting appropriate monitoring, especially in response to the introduction of regulations on operators engaging in high-speed trading<sup>2</sup>.

## 5. New challenges for the SESC: Efforts to enhance RegTech

(1) Research into status of financial technologies, authorities' use of recent

<sup>2</sup> This refers to operators who perform high-speed trading and are registered by the Prime Minister. In this case, high-speed trading refers to trades in which computer programs automatically make judgment on securities transactions and methods to shorten the time to transmit information are used.

### technologies, in Japan and abroad

Advancements in IT and the convergence of finance and IT (FinTech) in recent years have brought dramatic changes to the face of transactions subject to the SESC's monitoring, and the situation has raised the possibility that new risk factors may emerge. Alarmed by this situation, the SESC has set a “more active use of IT in the market monitoring system (RegTech)” as one of its focus policy areas and conducted research into trends in financial technologies in Japan and abroad and the status of introduction of IT by regulatory authorities and other parties, both domestically and abroad.

### (2) Issues under consideration

The results of this research have led to a realization that there is a risk that it may become difficult for the SESC to collect data from the subjects of investigation/monitoring due to the growing use of the block chain and cloud computing technologies. The SESC also sees the risk that monitoring of transactions may become difficult as the amount of data to analyse may grow to excessive levels as high-frequency and algorithmic trading are used more widely. In recognition of such risks, the SESC aims to explore ways to take advantage of advanced technology to continue conducting effective market surveillance.

As new IT developments, such as the growing use of virtual currencies, may have an impact on the market in various ways, the SESC aims to closely watch such developments.

## **6. Cooperation with relevant authorities, accountability**

### (1) Cooperation with relevant authorities

The SESC is working with self-regulatory organizations (SROs), such as financial instruments exchanges, on a daily basis in surveillance of trades, checks on the appropriateness of operations by member firms of such organizations, etc. The SESC also exchanged opinions with such organizations regularly and shared information on concerns, such as risk factors that can arise amid changing macroeconomic trends, to further strengthen cooperation with them. In FY2016, the SESC met with SROs 12 times to exchange views. It also exchanged opinions with FIBOs, certified public accountants and certified administrative procedures legal specialists.

In terms of communication with overseas regulators, the SESC members participate in discussions at the International Organization of Securities Commissions (IOSCO) and actively exchange thoughts with other overseas regulators. In addition, the SESC made a total of 31 requests to overseas regulators in relation to investigations into market misconduct using cross-border transactions based on the Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information of IOSCO in FY2016.

(2) Effective dissemination of information

The SESC strived to enhance effective dissemination of information about SESC's activities and messages by providing background and significance of each case or by easy-to-understand explanation, through press conferences, website, lectures and casebooks of monetary penalties or monitoring results to financial institutions. In FY2016, the SESC spoke at a total of 70 seminars and other occasions for market participants, certified public accountants, attorneys, etc.



**Chapter 2. Activity Report for Fiscal Year 2016****2-1. Market Oversight, Collection/Analysis of Wide-Ranging Information****1. Purpose of Market Surveillance**

Market surveillance is positioned as the entrance for information at the SESC, which aims not only to collect and analyze extensive amounts of information on overall financial and capital markets for the realization of comprehensive and proactive market surveillance corresponding to the changing environments surrounding the markets, but also to detect any suspicious market misconduct or services as early as possible by conducting market surveillance targeted at the primary and secondary markets.

For the above reason, the SESC receives a wide range of information from the public, such as ordinary investors, on a daily basis, and promptly circulates this information to the relevant divisions within the SESC (or to the relevant division within the Financial Services Agency [FSA], etc., if the information relates to affairs under the jurisdiction of the FSA, etc.). The SESC also cooperates with self-regulatory organizations (SROs) to gather a variety of information related to financial and capital markets. Based on this information, the SESC analyzes the background of individual transactions and market trends, examines transactions for possible market misconduct, and reports to the SESC's relevant divisions, if any suspicious transactions are discovered. The SESC has achieved effective market surveillance with the aid of the information collected, market trend analysis, and mutual cooperation in market oversight and collaboration among the relevant divisions of the SESC.

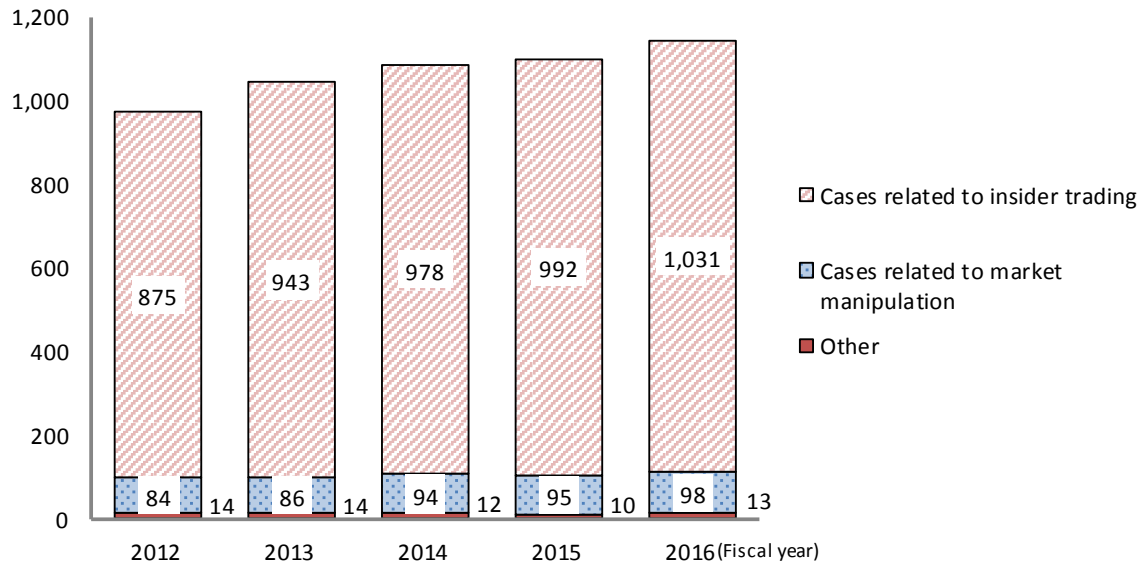
**2. Status of Market Oversight**

Changes in the external environment, including macroeconomic trends and advances in information technology, are affecting the forms of market misconduct. As market misconduct risk grew amid increased uncertainty in the global economy, the number of transactions the SESC examined in an effort to detect any suspicious market misconduct increased 45 from the previous year to 1,142 in FY2016.

The SESC reviewed 1,142 transactions consisting of insider trading (1,031), up 39 year-on-year; market manipulation (98), up 3; others, including use of fraudulent means and spreading of rumors (13), up 3. The number of material facts in which listed companies disclosed, which are subject to examination for detecting any suspicious insider trading, totaled 15,178, up 4.3 percent from the previous year's figure of 14,555. In terms of type of material facts, the number of revisions in earnings or dividend estimates is 5,243, which remained largely unchanged from the previous year's figure, as uncertainty in the economic environment surrounding businesses remained. Amid moves to enhance corporate governance and spreads of business strategy focused on return on equity, the number of business tie-ups, tender offers and share repurchases increased 11.

7 percent from the previous figure to 4,810.

**Fig. 2-1-1: Number of cases in which market oversight was conducted**



### 3. Overview of Market Monitoring

In order to conduct market monitoring in a comprehensive and flexible manner, the SESC enhanced its ability to collect and analyze wide-ranging information about markets by setting up the Office of Market Monitoring in the Market Surveillance Division in June 2016.

#### (1) Status of Information Collection, Whistle-blowing

##### (i) Efforts to Collect Information

The SESC focuses on information from the public, including ordinary investors and other market participants because it reflects candid opinions from market participants that can aid in triggering its investigation or inspection. The SESC believes it important to collect as much useful information and from as many people as possible. Therefore, the SESC stepped up its efforts by displaying posters and distributing leaflets requesting the reporting of information (posters have been displayed at train stations since FY2016) and requesting relevant organizations to include a link to the Information Service Desk page on their websites. As a result, a large number of reports from the public were provided to the SESC in FY2016, totalling 7,600, just as in the previous administrative year (7,758).

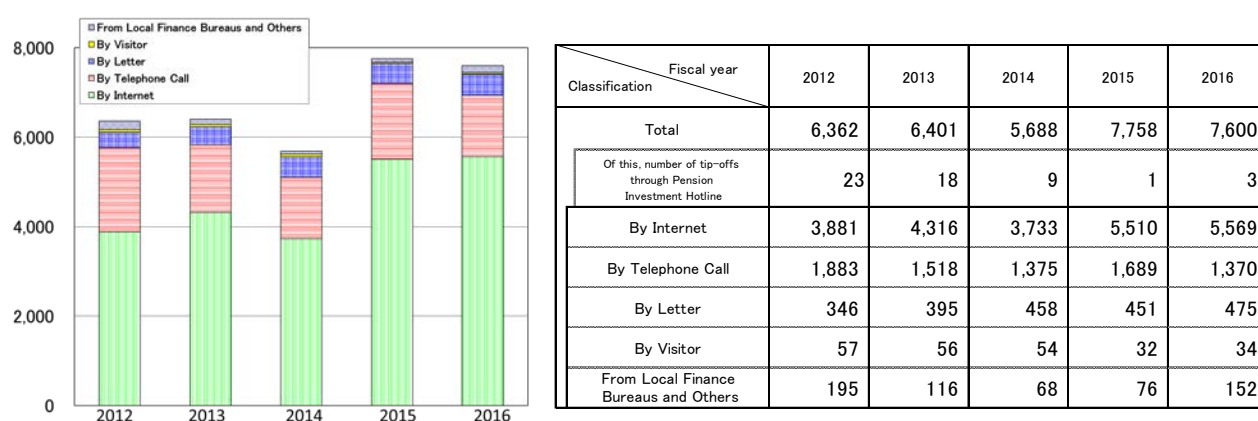
The SESC provides the Pension Investment Hotline dedicated to collecting highly useful information about the management of pension funds through which it accepts information such as on the service operation of fund management companies, and the SESC also requested relevant organizations to include a link to the hotline on their websites.

For whistle-blowers, the Contact for Whistle-blowing and Assistance provides

preparatory consultation and examines the contents before formal acceptance of complaints.

In FY2016, the SESC conducted interviews with individuals from private businesses to deepen understanding about their advanced initiatives and started to work out measures based on the interviews. In response to an amendment to the guidelines for administrative organizations under the Consumer Affairs Agency in March 2017, the SESC started working to revise its whistle-blowing system.

**Fig. 2-1-2: Status of information collection**



## (ii) Use of Collected Information

Information provided on suspicious transactions is examined at the Information Service Desk and then relayed to responsible divisions under the SESC so that it can be utilized in investigation and inspection, as described below.

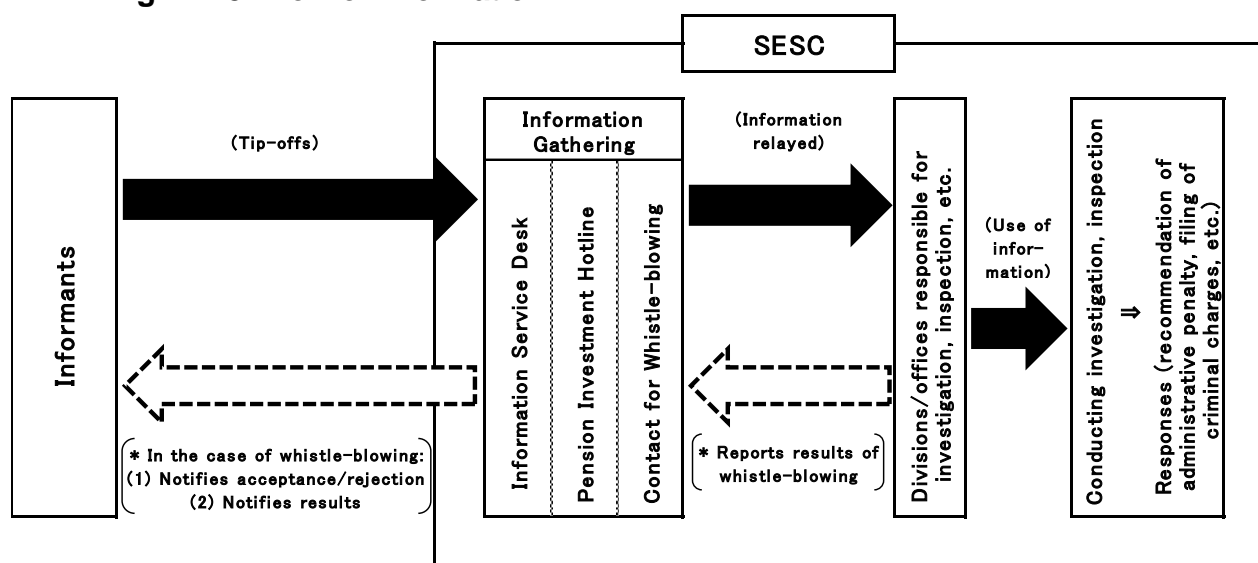
For example, there was an example in which an informant complained to the Information Service Desk that a financial instruments business operator said it had special information as it attempted to solicit an investment advisory contract. When the SESC inspected the operator on this information, it found out that the operator was giving the customer false information and issued a recommendation for administrative disciplinary action.

As information and tips are more useful when they are more recent and specific in the details of the alleged market abuse, the SESC urges informants to learn about the details of each contact point by referring to examples provided on the SESC website<sup>3</sup>. The SESC hopes that people with useful information will come forward and provide useful information as in the past.

In receiving information, the SESC takes every measure to protect the secrecy of the personal information of the informant and the content of the provided information.

<sup>3</sup>"Examples of desired information" on SESC website: <https://www.fsa.go.jp/sesc/watch/example.html> (Japanese version only)

Fig. 2-1-3: Flow of information



## (2) Market Trend Analysis

In combating "fraudulent finance" practices<sup>4</sup>, the SESC has utilized information gathered from market participants such as ordinary investors and securities companies, worked closely with directors of the securities and exchange surveillance departments and securities auditors responsible for accepting the submission of securities reports at local finance bureaus and financial instruments exchanges, and enhanced market monitoring by collecting and analyzing information that covers both primary and secondary markets. As a result, some listed companies have been forced to delist or been expelled from the capital market since 2007. However, it is hard to say that there are no problem companies in the market. There are now emerging cases in which problem companies try to hide market misconduct by taking advantage of complex finance schemes or issuance of shares to overseas funds for capital increases.

In FY2015, the SESC reformed its organizational structure so that its staff can manage and utilize the information gathered through market monitoring activities under a unified system. As the next step, the SESC plans to endeavor to increase the amount of information it collects while expanding the scope of the personnel who can directly utilize it to include staff responsible for market oversight at local finance bureaus to ensure active use of such information in market oversight.

Furthermore, the SESC is collecting and analyzing a wide range of information to have a grasp of market trends. In FY2016, for example, it collected and analyzed information on stock acquisition rights with an amended exercise price, issues related to detection of the involvement of anti-social forces in the entities receiving shares in third-party allotments. As a result of these efforts, the negative impact on the market from the stock acquisition rights with an amended exercise price was reduced through

<sup>4</sup>"Fraudulent finance" is a series of fraudulent trading practices comprised of inappropriate acts in the process of issuance of financial instruments (capital increase, etc.) or in the secondary market.

changes to the product scheme of such rights that in the past caused problems in MSCBs<sup>5</sup>. There have been cases, however, in which issuances were continued by slumping businesses even as share prices were falling significantly, which keeps the SESC on continued alert on these issuances. As for checks on the involvement of anti-social forces in the parties receiving share issuance in third-party allotments, there have been examples that raised doubts as to whether external agencies commissioned by issuing companies to conduct such checks actually conducted appropriate investigation. The SESC plans to work out measures to improve the situation and propose them to the relevant parties.

### **(3) Analysis Using Macroeconomic Approach**

In July 2016, the SESC introduced an approach of market monitoring that analyzes how global-level changes in the macro-economy and the markets (macroeconomic approach) may affect listed companies' earnings and looks at risk factors and environmental changes in Japan and overseas in a forward-looking manner.

In the SESC's previous approach of collecting information after problems occurring with individual companies, it took a long time to shed light on the actual circumstances leading to the problem. The SESC thus developed a method in which it identifies companies that have a risk of causing a problem at an early stage by analyzing how changes in the global economy may affect the earnings of listed companies and obtains various information about them beforehand so that it can take action early.

In FY2016, the SESC thus identified 14 sectors after analyzing the status of their earnings and the likely impact from foreign exchange trends, the trends of the Chinese economy and resource prices, and then analyzed individual companies belonging to these sectors. In conducting the analysis, it enlisted the assistance of private-sector analysts as well as collected information through interviews. The results of the analysis were shared among the SESC as well as the relevant divisions of the FSA.

The SESC has decided to periodically review the potential risk factors associated with changes in the economic environment, and conduct similar analysis in FY2017 with an expanded scope including the additional viewpoint of M&A (goodwill).

## **4. Survey Aimed to Enhance Securities Companies' Transaction-Screening Systems**

Japan's stock market is seeing the emergence of risk factors for new forms of market misconduct as the market structure undergoes change. Signs of these risk factors include occurrences of transactions that were suspected of market manipulations using multiple accounts and misconduct across markets, as well as the increase in high-speed

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<sup>5</sup>Short for moving strike convertible bond. This is a corporate bond that comes with the right to convert to equity shares. The holder can change the per-share conversion price for every specified period that occurs. This compares to convertible bonds, whose conversion prices to equity shares normally remain unchanged. MSCBs, whose conversion prices can be changed (often to a lower price), can profit the holders even if share prices fall.

transaction orders using computer algorithms. To find out about this state of risk factors, the SESC has conducted a survey on how transactions were screened by securities companies, which play the role of gatekeepers of the market.

The survey has highlighted problems in which securities companies were failing to build a transaction-screening system that addresses changes in the markets or the business models of securities companies. These included, for example, a problem in which a company failed to make sufficient system investment and instead continued to use a transaction-screening system it had introduced 10 years prior and another in which the transaction-screening division of another company was understaffed. There were also securities companies whose internal audit on their transaction screening was inadequate.

The survey also shed light on positive efforts at some securities companies, including introduction of sophisticated transaction screening systems developed by external vendors, development and introduction of enhanced screening criteria by individual companies, introduction of a function in the system to control forms of order that are likely to lead to market misconduct and execution of internal audits from the viewpoint of risk approach on the global level.

Based on the survey results, the SESC needs to encourage securities companies to engage in voluntary efforts to introduce best practices through securities-business monitoring on the theme of IT governance and collaboration with self-regulatory organizations, so that securities companies can build transaction-screening systems that are in line with their new business models.

## **5. Future Challenges**

### **(1) Encouraging brokers to enhance Market Surveillance Operation**

Based on the FY2016 survey results, the SESC aims to support broker's spontaneous efforts to build a market surveillance operation appropriately for their business models by taking advantage of the SESC/FSA monitoring and cooperation with self-regulatory organizations.

### **(2) Promotion to increase the amount of Information/Whistle-blowing Receipt**

In order to receive more useful information, the SESC aims to continue efforts to promote the informant contact and update the website of information-receipt page as user friendly. Furthermore, we aim to increase the amount of information according to the advice from the interviews with private companies that we began to conduct in FY2016.

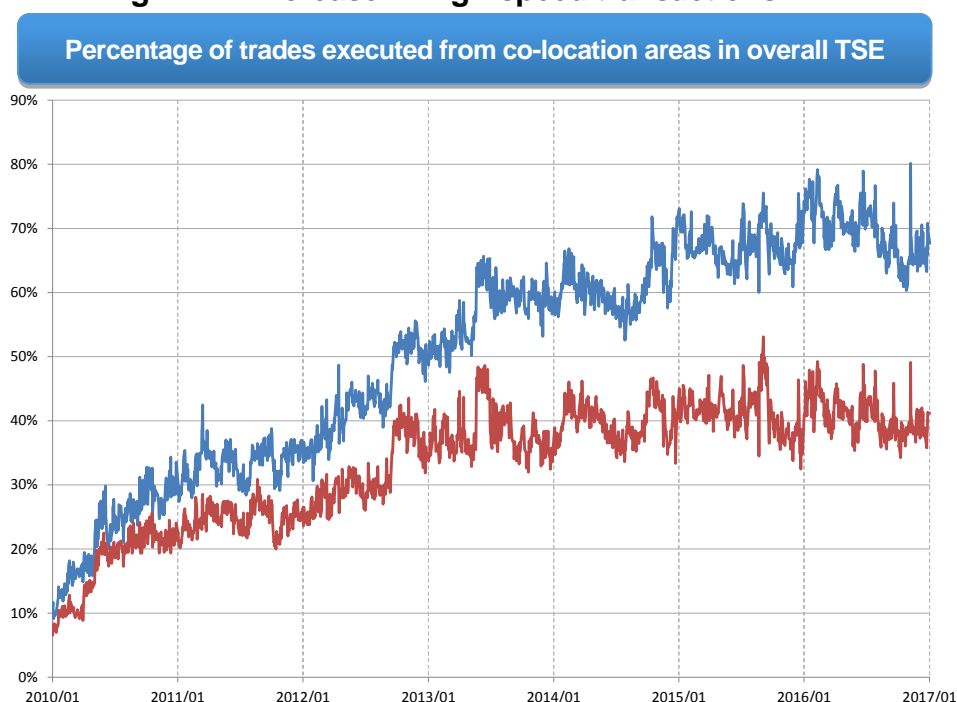
We aim also to update the whistle-blowing system according to changes in the Consumer Affairs Agency guidelines and will promote the system including the changes.

### **(3) Establishing Surveillance Operation in Response to Introduction of Regulations Controlling High Frequency Trading (HFT) Under Revised FIEA**

Since the Tokyo Stock Exchange began a co-location service in 2010, the percentage of transaction via the co-location areas<sup>6</sup> has increased significantly in terms of both orders and executions. That is indicating an increase in the share of HFT which is placed by computer algorithms (**Fig. 2-1-4**).

Under such circumstances, the bill to amend the FIEA, which calls for introduction of regulations controlling HFT, passed in May 2017. The SESC therefore plans to study and work out optimum ways of market oversight following this amendment.

**Fig. 2-1-4: Increase in high-speed transactions**



Source: Compiled by the FSA from data of Japan Exchange Group Inc.

#### (4) Enhancing Analysis of Macroeconomic Approach

The SESC aims to maintain and deepen relationships with private companies, try to identify a broad range of potential risk factors in a timely manner amid a highly uncertain global economic environment and strengthen cooperation between its relevant divisions so that its analysis can be conducted in a forward-looking manner.

<sup>6</sup> Trading facilities set up adjacent to the exchange's trading system. Investors can shorten the time it takes to execute transactions by placing transaction orders from servers set up in these facilities.

## **2-2. Investigation into Market Misconduct**

### **1. Purpose of Market Misconduct Investigation**

A market misconduct investigation which is subject to an administrative monetary penalty, deals in alleged market misconduct cases such as insider trading, market manipulation, spreading of rumors and use of fraudulent means. The purpose of the investigation is to ensure the fairness and the transparency of the securities markets, as well as, to protect investors as stipulated in the FIEA.

### **2. Changes in External Environment and Regulations**

Results of national elections in many countries, Brexit and other recent political developments have raised uncertainty in the global economy. In addition, advancements in IT and the fusion of finance and IT as often seen in the use of Fintech in recent years have brought dramatic changes to the style of transactions with the SESC monitoring, and the situation has raised the possibility that new risk factors may emerge.

The amendment to the FIEA in 2013 which took effect in April 2014 has introduced a ban on acts by company insiders who have learned about material facts through their duties to provide material facts or make trade recommendations for the purpose of allowing others to gain profits or avoid losses by letting them conduct transactions before publication of such material facts.

### **3. Key Activities**

The SESC conducts investigations into market misconduct in a swift and efficient manner by actively making use of the administrative monetary penalty system. It also makes efforts to take advantage of the information obtained through investigations into individual cases on its overall market monitoring operations in multi-faceted and multiple ways by, for example, discussing measures to address violations with industry organizations and so on.

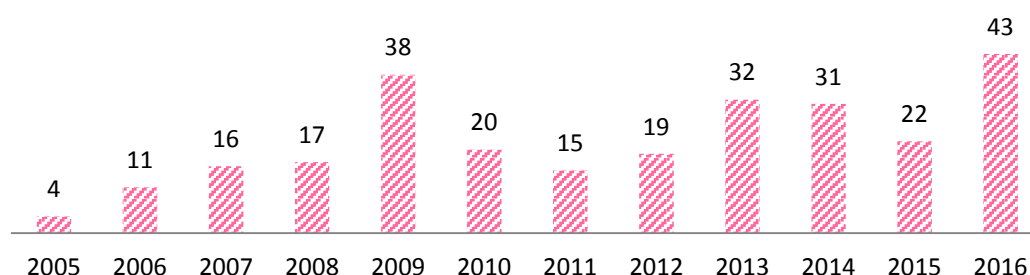
#### **(1) Insider Trading**

In FY 2016, the number of recommendations for an order to pay an administrative monetary penalty for insider trading amounted to 43. There were two cases out of 43 involving cross-border transactions.

These included, as in the past, serious violations in which listed company directors illicitly provided material facts, etc., to others. In addition, there were cases in which violators repeatedly conducted small-lot transactions in an attempt to disguise market misconduct.



**Fig. 2-2-1: Number of recommendations for an order to pay an administrative monetary penalty for insider trading**



Note: Figures include cases involving cross-border transactions.

There was an increase in the number of insider trading cases that involved material facts such as information on business tie-ups and tender offers as businesses have been focused on improving corporate governance and boosting their return on equity. There were also some cases involving such material facts as occurrence of data falsification.

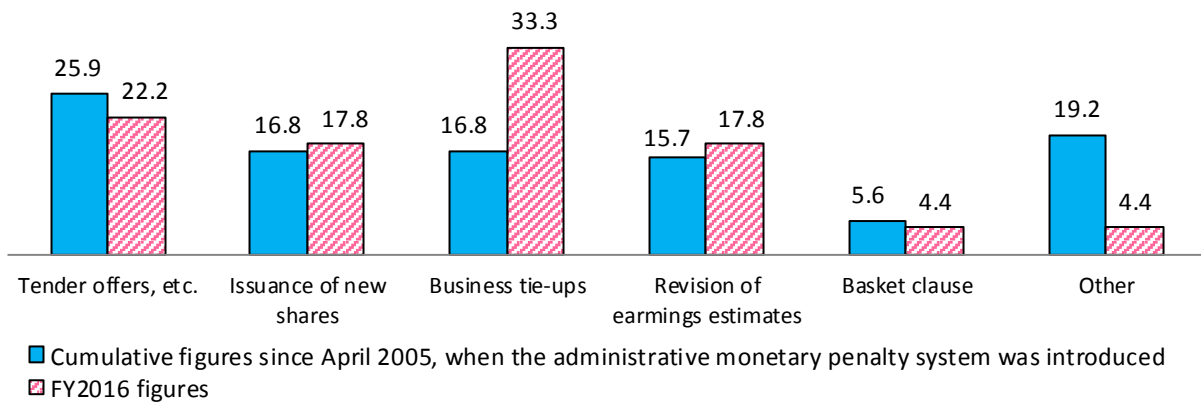
By types of material facts involved, the 43 recommendations for administrative actions issued in FY2016 included 15 cases involving information on business tie-ups (33.3 percent), 10 cases involving information on tender offers (22.2 percent), eight involving information on earnings revisions (17.8 percent), and another eight involving information on new share issuance (17.8 percent). The percentage of cases involving information on business tie-ups increased dramatically compared to the cumulative total since the introduction of the administrative monetary penalty system (figures in parentheses indicate percentage against the total 45 material facts).

The SESC also made recommendations for administrative action in two cases (involving two instances) that it recognized as involving information falling under the "material facts concerning operation, business or property of the listed company, etc. (or a subsidiary company of the listed company, etc.), that may have a significant influence on investors' investment decisions" specified under Article 166(2)(iv) and (viii) of the FIEA (i.e., the "basket clause") although the nature of the information did not constitute material facts as specified in Article 166(2)(i)-(iii) of the law (facts of decision, facts of occurrence and accounting information). Such cases have totaled 12 (involving 16 instances) since the introduction of the administrative monetary penalty system.

The case described above in the context of Article 166(2)(viii) was the first case that the basket clause regarding a subsidiary company of the listed company, etc., was applied.

**Fig. 2-2-2: Material facts by type**

(In percentage)



While investigating the above insider trading cases, the SESC identified many examples involving inadequate internal controls at businesses, including lack of awareness/efforts to examine material facts at listed companies, insufficient effort to control communication of information irrelevant to duties to external parties, and insufficient control on handling trading of own shares by shareholding associations.

#### Example of insider trading:

Description	Date recommendation was made Amount of penalty	Characteristics
After a subsidiary of a company listed on the first section of the Tokyo Stock Exchange created a scandal, a subsidiary employee sold shares in the parent with the knowledge of the scandal before it was publicized.	March 7, 2017 630,000 yen	<ul style="list-style-type: none"> <li>- The basket clause<sup>7</sup> was applied to the case as the scandal which occurred in the subsidiary company of the listed company was recognized as a factor that could significantly impact investors' decisions on investing in the parent company.</li> <li>- If a scandal occurs at a subsidiary company of the listed company, the listed company is required to judge whether it constitutes a material fact specified under the FIEA and, if it does, control the information appropriately.</li> </ul>

<sup>7</sup> The basket clause of the insider trading regulations is applicable to cases that involve the types of "material facts concerning operation, business or property of the subsidiary company of the listed company that may have a significant influence on investors' investment decisions" specified under the Article 166(2) (viii), even though such material facts do not constitute facts of decision, facts of occurrence and accounting information.

## (2) Market Manipulation

In FY 2016, the number of recommendations for an order to pay an administrative monetary penalty for market manipulation totaled eight. Of these, cases involving cross-border transactions or market manipulation by institutional investors totaled two.

There were cases highlighting that violators were adopting increasingly complex and cunning trading methods, including those in which they ordered transactions using multiple accounts at separate securities companies in an attempt to disguise market misconduct and others in which they induced other investors' algorithmic orders, reflecting recent developments in IT. There was also a case involving cross-border transactions in which a trader located overseas manipulated the market using methods such as "MISEGYOKU".

### Example of market manipulation:

Description	Date recommendation was made Amount of penalty	Characteristics
An individual investor manipulated the price of a stock listed on JASDAQ by making sell orders and matching orders through multiple online brokers in "TAITO-BAIBAI" (matching sell (purchase) orders with his/her own purchase (sell) orders).	March 24, 2017  12.28 million yen	<ul style="list-style-type: none"> <li>- The violator used multiple online brokers to execute "TAITO-BAIBAI" and "KAIAGARI-KAITSUKE" (placing a series of purchase orders at prices higher than the ones at which orders had been executed previously, which in turn caused the share prices to increase) to induce others' to purchase.</li> <li>- Even churning committed using multiple brokerages is exposed through transaction screening by securities exchanges or monitoring/investigation by the SESC.</li> </ul>

**Example involving institutional investor:**

Description	Date recommendation was made Amount of penalty	Characteristics
A securities company manipulated the price of a stock listed on the TSE first section using "KAI-MISEGYOKU" <sup>8</sup> .	December 6, 2016 219.88 million yen	<ul style="list-style-type: none"> <li>- This was an act committed as part of the securities company's proprietary trading.</li> <li>- The violator created a false impression that selling is exceeding buying by means of "KAI-MISEGYOKU" in which it repeatedly made a buy order without the intention to execute them and then cancelled it before the transaction was actually executed, inducing algorithmic trading orders by other investors to bid up the price.</li> <li>- The SESC also strictly responded to the company's other acts of market misconduct that took advantage of the characteristics of algorithmic trading.</li> </ul>

**Example involving cross-border transactions:**

Description	Date recommendation was made Amount of penalty	Characteristics
A foreign investment management company manipulated the prices of four stocks listed on the TSE first section by placing "KAI-MISEG	March 17, 2017 13.32 million yen	The violator placed "KAI-MISEGYOKU" to induce higher prices and then benefited by selling its holdings while at the same time buying shares to sell later, cancelled the "KAI-MISEGYOKU" while buying back shares when prices dropped after placing "URI-MISEGYOKU" and at the same time bought shares to sell later,

<sup>8</sup>"KAI-MISEGYOKU" means, e.g., placing low priority buy orders of a large number of shares at prices shown on the order book screen without the intention to execute them.<sup>9</sup> "URI-MISEGYOKU" means, e.g., placing a low priority sell.

YOKU” and “URI-MISEGYOKU <sup>9</sup> ” from an overseas location.		and repeated this entire process over several hours to its benefit.
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## 4. Future Challenges

### (1) Enhancing Information Provision to Realize Market Fairness

As part of efforts to discourage market misconduct, the SESC communicates information each time it issues a recommendation for administrative actions on violations using such media as posting on its website, briefing to news reporters, and articles in its email newsletter<sup>10</sup>. The SESC has raised awareness at listed companies on the importance for them of building a system to control insider trading through lectures and published articles. In the process of investigating transactions, the commission, when investigating a listed company found to have conducted insider trading, tries to look into the viability of its internal controls and, if a problem is found, it engages the company in dialogue to ensure its understanding of the issue. To discourage market misconduct such as market manipulation, the commission is striving to raise awareness at Japan Exchange Regulation and securities companies by meeting and discussing with them on issues.

The SESC aims to continue efforts to disseminate specific and easy-to-understand information on violation examples in ways that clearly show the background to the cases, and its description and problems when, for example, reporting about cases entailing recommendations for administrative actions and disclosure of cases in which an administrative monetary penalty payment order was recommended.

### (2) Future Challenges Related to Investigation into Cross-Border Transactions

#### (i) Enhancing Cooperation with Overseas Authorities

To combat market misconduct perpetrated on the global scale, the SESC has worked closely with overseas authorities by, for example, signing MMoU (Multilateral Memorandum of Understanding) to establish a framework to exchange information between securities watchdog bodies in different countries. Furthermore, in view of a recent increase in market misconduct cases by overseas investors using cross-border transactions, the SESC aims to further step up efforts to enhance communication with overseas authorities and solidify its network to enable effective exchange of information and look into the reality of

<sup>9</sup> ” URI-MISEGYOKU” means, e.g., placing a low priority sell.

<sup>10</sup> SESC email newsletter: <http://www.fsa.go.jp/haishin/sesc/en/index.html>

market misconduct involving cross-border transactions.

**(ii) Training Staff to Develop Skills to Deal with International Violations**

For effective investigation into market misconduct that takes advantage of cross-border transactions, it is essential for the staff involved to have foreign language skills of a level that can handle highly specialized topics and communication skills grounded on international perspectives in working with their counterparts at overseas authorities and analyzing information. Training the staff to develop these skills, therefore, is an important issue for the SESC.

For this, the SESC aims to help the staff develop skills to analyze and investigate market misconduct using cross-border transactions by engaging them in exchange activities with their counterparts at overseas authorities and dispatching them to participate in training programs at overseas authorities, as well as strengthen the communication network with overseas authorities to help develop the staff that can deal with cases that require international skills.

**(iii) Enhancing Readiness to Handle Increasingly Complex, Diversified Financial Instruments, Transactions**

As innovation in the financial/capital markets advances on a global scale, financial instruments and transactions are growing more complex and diversified. In terms of form of transaction, use of HFT (High-Frequency Trading) is growing.

In order to adapt itself to such changes, the SESC aims to enhance its ability to collect information by striving to deepen ties with overseas authorities and utilize the obtained information in its market monitoring, and work closely with self-regulatory organizations such as Japan Exchange Regulation to grasp the reality of the situation regarding new financial instruments and forms of transactions so that it can utilize the acquired knowledge in its investigation into market misconduct.

## Providing insider information or a trade recommendation based on such information is a violation of the law!

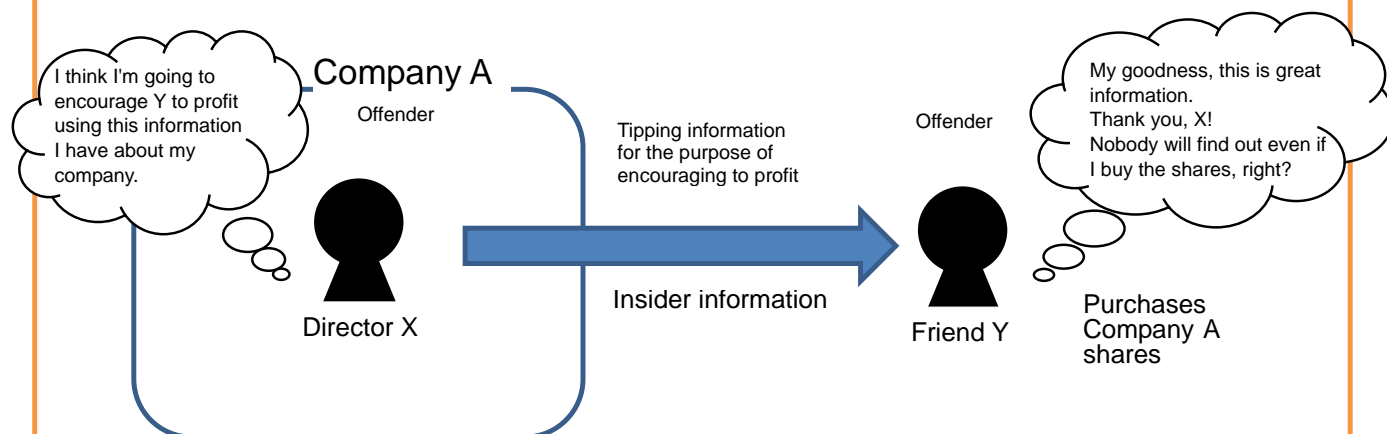
### 1. Message to Company Insiders

#### © Control of Insider Information

Let's take a look at a case in which a director of a listed company gave insider information to a friend, and the friend used that information to conduct insider trading.

Director X of listed Company A came to know a material fact through his duty at the company and provided that information to Friend Y for the purpose of encouraging Y to gain profit by purchasing shares in Company A before the company publicized the material fact. The friend purchased shares in Company A before publication of the material fact, for his personal gain.

Friend Y's act is insider trading. However, Y would not have been able to conduct the insider trading unless Director X provided him the insider information about Company A to Y as a way to gain easy profits.



This act by a director of a listed company that violates the regulation on information providing occurred due to a lack of awareness of the rules controlling insider trading, which an individual in a position like him is expected to have. It is a serious issue.

The regulation on providing and trade recommendation, as specified under Article 167-2 of the FIEA, took effect in April 2014. Trade recommendation without providing insider information is also subject to this regulation.

By the end of March 2017, the SESC has made recommendations for administrative action in eight cases and filed criminal charges in one case in relation to violation of the regulations on providing and trade recommendation, committed by company insiders of listed companies.

## **2-3. Inspection, Information Gathering on Disclosure Requirement Violations**

### **1. Purpose of Disclosure Statement Inspection**

Disclosure requirements in the FIEA are aimed at protecting investors by ensuring provision of information deemed important for them to make investment decisions in the primary and secondary markets for financial instruments. Specifically, they require issuers of financial instruments to submit disclosure documents, such as Securities Registration Statements and Annual Securities Reports detailing information including the business description and financial details of the issuer and for the prime minister to make the documents available for public inspection, so that such information is disclosed to the public.

Investors make investment decisions based on the information in the disclosure documents submitted by issuers of financial instruments, but if such documents contain false information or fail to contain information that must be disclosed, investors who make investment decisions using these documents may sustain unexpected losses.

To avoid this, the SESC conducts disclosure statement inspections so that it can ask submitters of defective disclosure documents to correct them so that correct information is provided to investors and make recommendation for administrative monetary penalty on financial instrument issuers who violated disclosure requirements by, for example, including serious misinformation in the documents. The SESC also engages in various activities to prevent occurrence and recurrence of such disclosure regulation violations.

### **2. Disclosure Statement Inspections and Violation Trends in FY2016**

The SESC launched disclosure statement inspection in 25 cases, of which 15 were completed in FY2016. Among these 15 cases, the SESC made recommendation for administrative monetary penalty in five in which serious misinformation was found in disclosure documents. The SESC also urged submitters of disclosure documents that were not found to contain serious misinformation but recognized as requiring correction to also submit a correction report, although the submission was on a voluntary basis. Two of the 15 closed cases were subject to this measure. The SESC conducts disclosure statement inspection on companies that voluntarily submitted reports on correction of disclosure documents, as necessary, to check the functioning of their internal controls.



Number of completed inspections		15 cases
Of which...	Cases for which imposition of administrative monetary penalty was recommended	5 cases
	Cases for which penalty was not recommended but issuers were urged to voluntarily submit correction reports	2 cases

In addition to the above activities, the SESC started ongoing monitoring on large listed companies from a forward-looking, macroeconomic perspective in an effort to prevent disclosure regulation violations, analysis of disclosure documents focused on specific items, and in-depth analysis of nonfinancial, as well as financial, information in disclosure documents. This was introduced in response to disclosure regulation violations by one of Japan's top global companies and its inadequate control systems regarding an overseas subsidiary that came to light over the past few years.

### (1) Cases for Which Imposition of Administrative Monetary Penalty Was Recommended

#### Key Cases:

Description	Date recommendation was made Amount of penalty	Direct causes	Root causes
A company booked inappropriate sales by disguising sales of products to an affiliated party as being sold to a third party, by selling them to a conduit company it had set up for the purpose.	April 15, 2016 258.48 million yen	The company focused excessively on the growth of operations under a sales-first policy amid intensifying competition.	- Directors' lack of awareness of compliance - Dysfunctional governance
A company solicited purchase of stock acquisition right certificates without registering with the prime minister although there were no circumstances exempting it from this requirement ("Solicitation of Securities by Unregistered Agents").	March 24, 2017 22.41 million yen	The company was facing difficulty in raising funds as it was unable to establish a viable business model.	- Directors' lack of awareness of compliance - Dysfunctional governance

In many cases, the direct cause that led the companies to disclosure regulation violations, triggering administrative penalty recommendations, was the desire to pad revenues after they failed to achieve their desired growth target amid a changing business environment and intensifying competition, a fear of being disqualified from listing as their sales dropped, or finding it impossible to achieve publicly disclosed earnings targets.

In terms of cause on more fundamental levels, many of the cases were triggered by company directors' lack of awareness of compliance, which in some cases led them to lead attempts to violate disclosure regulations or a total lack of governance that resulted in boards of directors or auditors failing or unable to prevent violations of disclosure regulations.

The SESC's view is that recurrence of these violations is inevitable unless the management members of the violating companies are made aware of these root causes so that the companies themselves can correct them. The SESC thus aims to deepen dialogue with these companies on their root causes.

## **(2) Case in Which Voluntary Corrections Were Made in the Process of Disclosure Statement Inspection**

### **Key Cases:**

Description	Direct causes	Root causes
<p>(1) A company booked an additional investment amount received from a business partner as minority interests (i.e. part of equity) when in fact it had to be booked as deposits (i.e. Debt) after it used the amount for purposes other than the originally intended use.</p> <p>(2) A company booked an amount of compensation received for the cancellation of a sales contract, which should have been booked as non-operating income, as consulting fee revenue.</p>	Inadequate system to screen accounting processing.	Dysfunctional governance

As stated above, the SESC urges submitters of disclosure documents to voluntarily release a correction report when the commission, as a result of disclosure statement inspection, finds details that need correcting to ensure accurate information is provided to investors, even if the document is not judged to

contain material misinformation that can affect investors' investment decisions.

As the SESC found that dysfunctional governance at these companies led to the misinformation in the disclosure documents, it had in-depth discussion with company officials on the issue and asked them to step up measures to ensure appropriate disclosure is made.

### (3) Cases in Which Interviews Were Conducted to Discover How Internal Controls Were Working

#### Key Cases:

Description	Direct causes	Root causes
A company was found to need to correct disclosure documents because what it judged to be a nonconsolidated subsidiary actually had to be treated as consolidated affiliate in its accounts after its significance for the parent grew as a result of balance-sheet corrections made to rectify inappropriate accounting practices at the subsidiary.	Defective control over the subsidiary	Dysfunctional governance
A manager of a company's sales division padded profits by booking lower costs of goods sold than actual levels by disguising the amount of discount on sales to a customer as an equivalent amount of returned goods in an attempt to make his division's sales performance appear better than it was.	Under a situation where internal controls on inventory management were not functioning, views on sales performance outlook by the sales division manager and his supervisor differed, and the manager attempted to pad profits.	<ul style="list-style-type: none"> <li>- Dysfunctional governance</li> <li>- Lack of internal communication</li> </ul>

Even when a company not subject to disclosure statement inspection submits correction reports for disclosure documents on a voluntary basis, the SESC, if necessary, checks to see if the corrections are appropriate and once again remind the company of the root causes that led to the corrections, as well as conducting disclosure statement inspection on the company by, for example, conducting interviews as a way to prevent recurrence of false statements.

Of the cases where such interviews were conducted in FY2016, many of the false statements that led to corrections were the results of attempts by sales or operational division managers to pad the performance of their divisions through inappropriate means such as the booking of fictitious sales. These cases were caused by a lack of awareness of compliance on the part of the managers, but also, on a fundamental level by dysfunctional governance, or the company's failure to create an organizational system to check inappropriate practices by managers.

The SESC is thus also discussing with companies that voluntarily submitted correction reports for disclosure documents the root causes identified as having led to the false information, as a way to prevent recurrence of disclosure regulation violations, such as use of false statements.

#### **(4) Disclosure Statement Inspection on Persons Alleged to Have Committed Specified Act of Involvement**

The SESC is actively conducting inspections on acts that facilitate or incite submission of disclosure documents containing material misinformation ("Specified Acts of Involvement").

In FY2016, the SESC conducted disclosure statement inspection on a case in which a company submitted false disclosure statements containing fictitious sales. In this process, allegations arose that a certified public accountant performing auxiliary work for the audit of the company's accounts may have destroyed evidential material to help cover up the fictitious sales, which led the SESC to investigate the accountant on suspicion of Specified Acts of Involvement. The investigation did not confirm such an act, but this type of allegations remains under the scope of the SESC's attention.

### **3. Future Challenges**

Starting in FY2016, the SESC aims to continue to collect and analyze information on large listed companies in a forward-looking manner from a macro-viewpoint by focusing on potential disclosure regulation violations that can arise amid changes in the economic environment and political developments. This is to nip disclosure regulation violations by large listed companies in the bud.

For companies other than such listed companies, the SESC will continue to analyze information and screen for companies that may raise suspicion of violating disclosure regulations from a micro-viewpoint by, for example, focusing on specific account items in the financial statements.

Specifically, the SESC believes it is important, as a way to prevent disclosure regulation violations, to focus on the following risks and step up efforts to collect and analyze information on listed companies that are deemed prone to be affected:

- (1) Risk of account falsification at listed companies that rely heavily on overseas

sales and are seeing their operations slump amid increasing uncertainty in the global economy amid factors including a slowdown in the Chinese economy, falling resource prices, Brexit, and the change of government in the United States;

- (2) Fundamental risk of governance falling into dysfunction, which is often the case with listed companies found to have falsified corporate data or those whose overseas subsidiaries found to have committed inappropriate accounting practices;
- (3) Fundamental risk of companies engaging in accounting falsification associated with the handling of goodwill amid increasing instances of corporate mergers and acquisitions, and;
- (4) Risk of listed companies engaging in account falsification after their earnings slump amid failure to adapt to the changing business environment.

In view of the fact that many of the found instances of disclosure regulation violations are dysfunctional internal controls and governance at the companies, the SESC finds it necessary to deepen analysis of nonfinancial information related to governance, including the "status of corporate governance" section of securities reports, in addition to financial information in disclosure documents, in screening for suspicious companies.

## Case study

### Make internal controls work for fair disclosure!

## 2. Message to Listed Companies

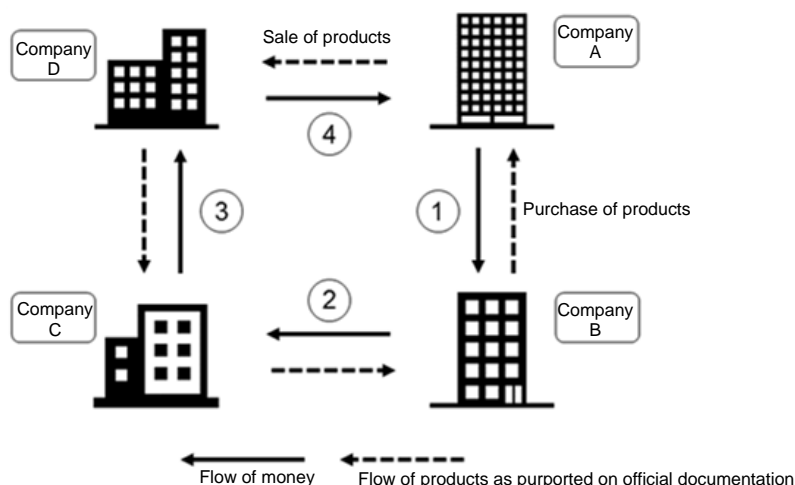
### © Case of a Listed Company That Used Round-Tripping to Pad Sales

Let's take a look at a case where a listed company used round-tripping on products to book fictitious sales.

Company A purportedly booked sales on selling products purchased from Company B to Company D. But after close inspection, A's accounts payable to B and accounts receivable from D for this transaction were found to have been executed through an "A → B → C → D → A" circulation of funds.

This was a scheme to enable A to book fictitious sales and was plotted under the representative's initiative to achieve the company's earnings targets.

The direct cause of this illegal act can be attributed to A's excessive focus on achieving earnings targets, but on a fundamental level, it was caused by the company's chief executive who irresponsibly thought all it had to do was achieve earnings targets and the other members of the management who were not able to stop the chief executive, who was the leading shareholder.



We at the SESC believe it is important that people working at listed companies remind themselves of the importance of compliance and once again make sure that the compliance systems at their companies are not just a formality but are actually functioning, so that effective internal control is maintained.

## **2-4. Monitoring Financial Instruments Business Operators**

### **1. Purpose of Monitoring of Securities Businesses**

In view of the SESC's mission to ensure fairness and transparency of the markets and the protection of investors, contribute to sound development of markets and sustainable economic growth, monitoring of Financial Instruments Business Operators ("FIBOs") aims to ensure investors' confidence in the markets.

The SESC accurately grasps the operation and financial status of FIBOs through seamless on-site/off-site monitoring. If, as a result of monitoring, a problem is found to ensure that FIBO operates in compliance with relevant laws, regulations and market rules, the SESC recommends the prime minister and the FSA commissioner to take appropriate measures or provide necessary information to supervisory departments.

The SESC encourages FIBOs to enhance self-discipline to perform their function as market intermediaries and gatekeepers through monitoring.

### **2. Changes in External Environment**

FIBOs, especially securities companies, earn much of their profits from the business of intermediating transactions. This makes them vulnerable to market trends. The external environment is undergoing a change in various aspects. Specifically, on the domestic front, they face a changing customer base due to the aging population, and a changing investment environment with the introduction of negative interest rates, even as the nation's stock markets have been on a recovering trend since 2013. Globally, FIBOs face challenges from the slowdown in growth in Chinese and other emerging economies as well as Brexit.

In order for FIBOs to operate their businesses stably under such changes in the environment, it is important that they manage risk appropriately and aim to secure stable profits by expanding and enhancing their customer base by winning their trust through provision of products and services that meet users' true needs and benefit them. On its part, the SESC believes it is its mission to support the Japanese public's stable asset formation and promote expansion of the nation's investor base by helping to create a market where investors have peace of mind when making investments.

In addition, the growing threat from cyberattacks, combined with the growth of FinTech, has made it imperative for FIBOs to implement measures to ensure the stability of their system platform.

### **3. Achievements of Securities Business Monitoring (Risk Awareness, Etc.)**

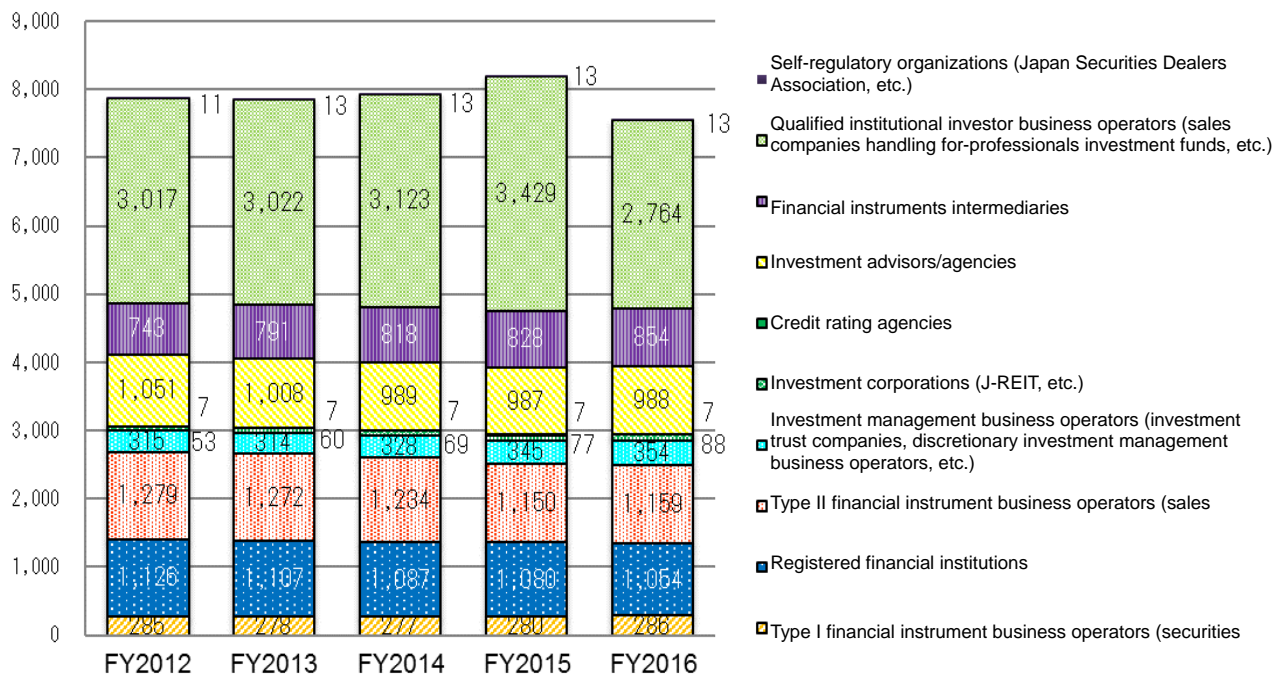
Meanwhile, the number of FIBOs subject to monitoring by the SESC has increased to approximately 7,000 in total (Fig. 2-4-1), and their service details vary widely. As

such, the importance of conducting efficient monitoring based on analyses of macro prudential aspects, such as the given economic environment and industry trends, is growing further.

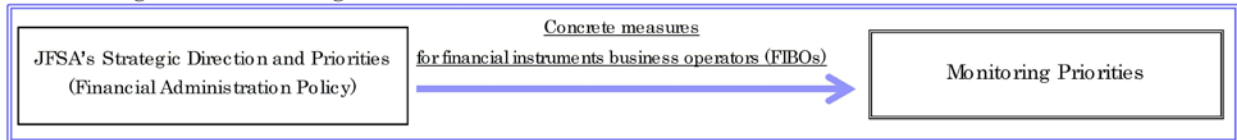
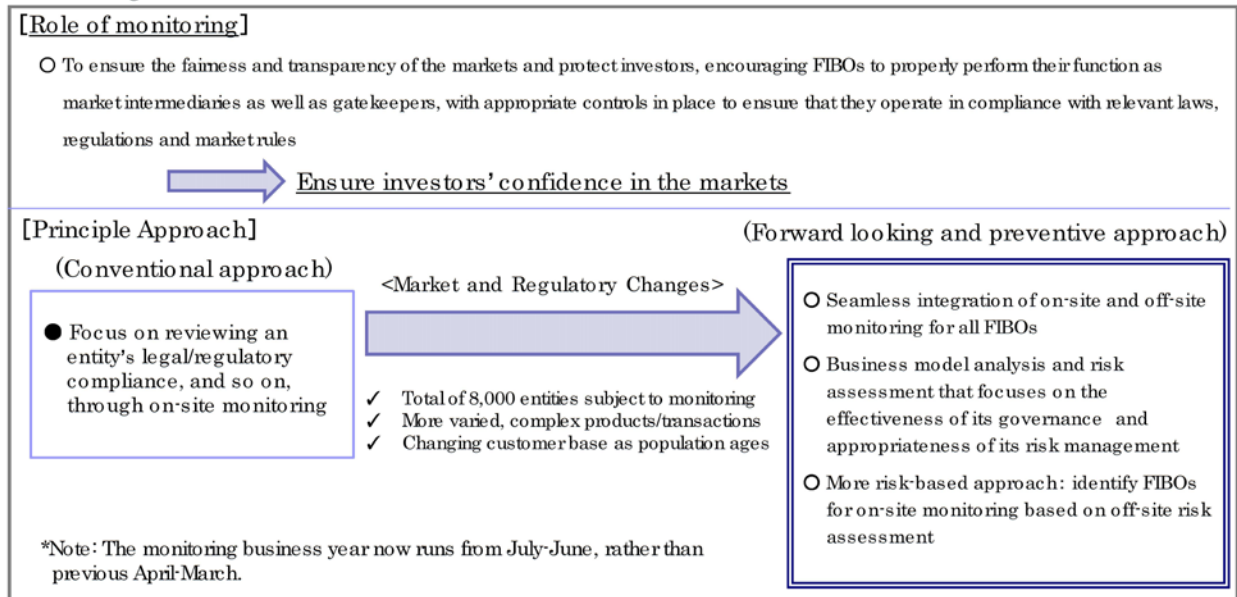
As a new effort for the monitoring of securities businesses, the SESC started in July 2016 to integrate on-site and off-site monitoring of all FIBOs into a seamless process, and to assess risks based on their business type, size and other characteristics. In assessing risks, it closely examined how services are operated at individual financial instruments business operators, while conducting peer reviews of major securities companies that focus on the situation of governance, IT system management, risk management and internal audits, etc.

Based on the risk assessment results, the SESC selected FIBOs to be subject to on-site monitoring using multi-faceted risk evaluation criteria. In on-site monitoring, it conducted in-depth analysis of the products and trading schemes of the operators and examined the appropriateness of the operation of their services. When problems were detected, the SESC further looked into their root causes.

**Fig. 2-4-1: FIBOs subject to securities business monitoring**





**Fig. 2-4-2: Monitoring Priorities for Securities Businesses (July 2016- June 2017)****《Positioning of the Monitoring Priorities》****《Monitoring Priorities for Securities Businesses》**

\*Released October 2016

**(1) Securities Companies**

The SESC conducted risk assessment of securities companies' business models, along with the appropriateness of its risk management in light of its business model, giving consideration to their business types, sizes and other characteristics and based on the idea of the "three lines of defense"<sup>10</sup>.

While many of the securities companies were found to have viable law compliance systems, there were only a limited number of companies in which the internal audit function, or the third line of defense, was actually examining or assessing the proper functioning of the first - front-office functions - and the second - risk management and compliance functions – lines of defense. The SESC views the functioning of their internal audit as insufficient overall.

High Frequency Trading has grown to represent about 70% of all sell and buy orders in the market. Under such circumstances, securities companies that handle High Frequency Trading using direct market access (DMA) services and computer algorithms are required to have a viable trade surveillance system. But the degree

<sup>10</sup> As the first line of defense, its front-office functions, which are responsible for recognizing and managing risk directly related to their day-to-day operations. As the second line of defense, its risk-management and compliance functions, which oversee the risk management implemented by the front-office functions and verify its effectiveness. As the third line of defense, its internal audit functions, which are responsible for verifying the controls implemented by front-office, risk-management and compliance functions.

of preparedness in terms of trade surveillance was found to vary from company to company.

The SESC found that large securities companies had risks related to establishing customer-first business practices in retail service and the sustainability of business models in domestic wholesale and overseas operations, while bank-affiliated large securities companies had a latent risk of conflict of interest related to efforts to promote integrated banking and securities services. Furthermore, foreign securities companies had risks related to judgment of suitability in the provision of derivative products to meet the needs of domestic customers who face a lack of viable investment targets, while online brokerages had risks associated with the diversification of products and sales channels. Meanwhile, local securities companies had risks associated with uncertainty over their business models that relied heavily on brokerage fees for stock trading for revenues while securities companies affiliated with regional banks had risks associated with the sustainability of their business models that typically relied on collaboration with their parent banks.

Of the 25 securities companies that were subjected to on-site monitoring in FY2016, the SESC notified 19 about problems it had found, and made recommendations for administrative disciplinary actions on 10 that were found to have committed serious breaches of law.

#### Key Cases:

Company name	Date recommendation was made	Description
Credit Suisse Securities (Japan), Ltd.	April 15, 2016	The SESC found that the company did not always check to see if non-public information about listed companies its analysts obtain constitutes material corporate information that influence stock price, and that it actually solicited customers to buy stocks by providing them with material corporate information that it had obtained, prior to the announcement of the information.

Nobata Securities Co., Ltd.	Jun. 6, 2016	The company was found to have failed, in selling corporate bonds backed by medical accounts receivable, to look into the product details or the status of the issuer and done little in the way of post-sales monitoring. As it had very little knowledge of the bonds, the company made representations that were misleading about the safety of the product and included information that contradicted the facts in promotional material in selling the bonds to customers.
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## (2) Investment Management Business Operators

As a way to set key points for effective monitoring, the SESC surveyed large investment management business operators using questionnaires asking about the status of governance, management of conflicts of interest, investment processes, risk management, compliance, internal audits, etc., and profiled their investment management services.

The profiling revealed these operators generally had sufficient management structures of investment processes, risk and compliance, and had developed internal rules and reporting structures, but in terms of governance, they were found to still have enough room for directors to actively participate in discussion at the board meetings, and their conflict of interest management lacked specific measures which made the management inadequate.

Of the seven investment management business operators that went through on-site monitoring in FY2016, the SESC notified four about problems it had found. It also made recommendations for administrative disciplinary actions on two of them as they were found to have a serious problem in terms of investor protection in their provision of discretionary investment management services.

**Key Cases:**

Company name	Date recommendation was made	Description
Japan Asia Asset Management Co., Ltd.	Feb. 28, 2017	The SESC had found in the previous round of inspections that the company had violated the duty of due care of a prudent manager in their discretionary investment management service. To the order for business improvement subsequently issued, the company responded by saying it would build a system to monitor financial instruments managed under the service. However, in the last on-site monitoring, the SESC found that it still had problems regarding investor protection in the way it operated some of its services, including the failure to monitor the status of investment of the financial instruments or the operational system at the company it commissioned to manage these financial instruments.

**(3) Type II Financial Instruments Business Operators**

The SESC conducted on-site monitoring on type II financial instrument business operators that it judged to have high risks based on the results of off-site monitoring focused on businesses invested in by their funds and dividend yields, etc. These on-site monitoring shed light on cases in which such operators diverted some of the invested funds to areas outside of their stated purposes and operators made misleading representations on their websites.

Of the 12 operators that went through on-site monitoring in FY2016, the SESC notified nine about problems it had found and made recommendations for administrative disciplinary actions on six that it found to have committed serious breaches of law.

**Key Cases:**

Company name	Date recommendation was made	Description
Minnano Credit, Inc.	March 24, 2017	The company had solicited investors to acquire equity interests in silent partnership (Tokumei Kumiai) agreements which purport to lend money to a credit service provider. The SESC found that the company made misleading descriptions regarding the risk of investment turning sour due to the irrecoverable loans of the provider in its solicitation. The SESC also found some of the company's practices were seriously undermining investor protection, including the use of some of the invested funds to repay the debts of the company's head.

**(4) Investment Advisors/Agencies**

The SESC monitored investment advisors/agencies with a particular focus on representations on their websites, and conducted on-site monitoring on those found to have high risks, which shed light on a case in which investment advisory services were being solicited by providing investors with false information or conclusive judgment, and another in which a violator had an operator of a website that ranks investment advisories to always rank it high for no substantial grounds, giving investors a false impression that it is a highly-rated investment advisory.

Of the 14 investment advisors/agencies that went through on-site monitoring in FY2016, the SESC notified nine about problems it had found and made recommendations for administrative disciplinary actions on four that it found to have committed serious breaches of law.

**Key Cases:**

Company name	Date recommendation was made	Description
AM Online Co., Ltd.	Dec. 6, 2016	<p>The company was found to have solicited investment advisory contracts by touting itself as having obtained information about stock speculators when it actually had no such information. The SESC also found the company tried to arouse interest in investing by stating that investors could be certain they could profit based on factors that were in fact uncertain in its attempts to solicit contracts for its services.</p> <p>The company also ran advertisements on multiple websites that rank investment advisories based purportedly on evaluation by the public, for which it actually paid advertisement agencies to have those sites always rank it high, which was deemed an act of placing advertisements that include misrepresentations that led investors to mistakenly believe it is a highly-rated advisory.</p>

**(5) Qualified Institutional Investor Business Operators**

The SESC looked into the operations of qualified institutional investor business operators<sup>11</sup> (hereinafter referred to as "QII Business Operators") focusing on personal relationships they had with malicious operators that had been found in past on-site monitoring to have spent or misappropriated invested funds, and conducted on-site monitoring on those it deemed to have a high risk of violations. This revealed there were still similar violations, including misappropriation of invested funds and unregistered operators engaging in financial instruments business without statutory registration.

Of the 27 QII Business Operators that went through on-site monitoring in FY2016, the SESC notified 25 about problems it had found and made recommendations for

<sup>11</sup>Ordinarily, operators of fund services (i.e. management of funds and solicitation of sale) are required to register with the prime minister, but operators can also operate such services by submitting a simplified application if they meet specified requirements. Operators that have made such an application are called qualified institutional investor business operators.

administrative disciplinary actions on 13 that it found to have committed serious breaches of law.

### Key Cases:

Company name	Date recommendation was made	Description
Tokyo Asia Leprechaun Co., Ltd.	Oct. 7, 2016	The SESC found that the company did not meet the requirements to qualify as a QII Business Operator, and was operating a type II financial instrument business and investment management business without statutory registration, as well as paying dividends in amounts that actually exceeded investment gains by using the invested funds, diverting invested funds to pay redemption of money for cancellation in amounts that exceeded appropriate level, undermining investor interests.
Wolk Huren Japan Co.	Feb. 10, 2017	The company was investing in investment partnerships, etc., managed by other QII Business Operators, but it was found to have been collecting consulting fees from these partnerships and using the funds from these fees for these investments, which was deemed an act of disguising an appearance of a qualified institutional investor. The SESC also found the company was operating an investment advisor/agency service without statutory registration.
IN Consulting Co., Ltd.	March 22, 2017	The SESC found that the company failed to separately manage investment assets of its fund and its own assets and misappropriated a portion of the investment assets to paying expenses such as rents for its office and wages for its employees. It also found the company had not checked or examined how the prices were calculated



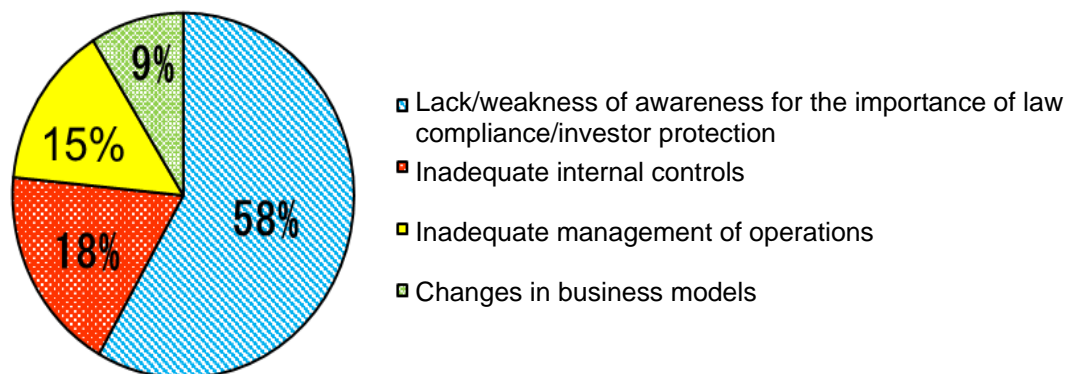
		when its private equity fund acquired unlisted shares, undermining investor interests.
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### (6) Analyzing Root Causes of Problems Found

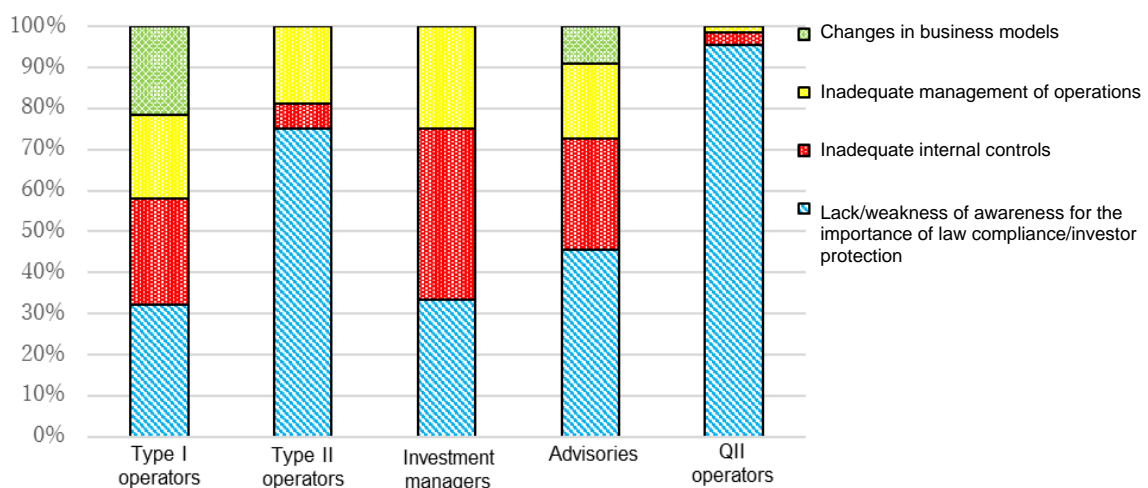
When a problem is found through on-site monitoring, it is important for the SESC to go beyond just identifying violations of laws and regulations and to conduct additional analysis to identify root causes of any identified problems through review of the FIBO's management policies and strategy, its governance, and its personnel and remuneration policies. The root cause analysis should help to encourage FIBOs to develop an effective response to prevent recurrence of similar problems in the future.

The SESC thus looked into the root causes of the problems it notified FIBOs about after on-site monitoring conducted in FY2016, and classified such causes by type. The results are shown below.

**Fig. 2-4-3: Types of Root Causes (all service types)**



**Fig. 2-4-4: Types of Root Causes (by business type)**





Overall, violations of the type, "lack/weakness of awareness for the importance of law compliance/investor protection," were the most frequent, representing about 60%, followed by "inadequate internal controls" and "inadequate management of operations" in that order.

By business type, 70 percent of the problems the SESC notified Type II business operators about and 90 percent of those pointed out to QII Business Operators fell under the category of "lack/weakness of awareness for the importance of law compliance/investor protection." These included many cases in which the heads of the companies themselves lacked or had only slight awareness.

#### **4. Issues That Need Addressing in Monitoring Securities Businesses**

##### **(1) Enhancing Monitoring of Securities Businesses**

In order to further enhance monitoring of securities businesses, the SESC aims to raise the precision of risk assessment by organically linking a wide range of information through timely information gathering focused on products handled by FIBOs, the substance of invested businesses, the personal relationships of people involved in problem cases as well as horizontal reviews of operators under themes that encompass them, to discover issues and problems of financial instruments business operators at an early stage and establish a forward-looking monitoring system that can nip potential violations in the bud.

In conducting on-site monitoring, the SESC aims to conduct to-the-point examination based on the results of off-site risk assessment, look into root causes whenever it finds a problem, and use the findings in working out effective measures to prevent recurrence of the problems.

##### **(2) Enhancing Feedback**

For cases in which the SESC did not see problems outright in on-site monitoring of a company but found that it has potential issues in relation to the sustainability of its business model, among others, the SESC aims to share perspectives on the key issues with the company's management, give feedback on them as "issues require attention" in the monitoring results notification and continue to monitor them in order to encourage them to improve the situation.

Furthermore, the SESC provides feedback of off-site monitoring to individual FIBOs, where necessary to ensure they operate their business appropriately.

##### **(3) Adapting Monitoring System to Changing Regulatory Environment**

In response to the introduction of regulations on operators performing High Frequency Trading, the SESC aims to enhance the system to conduct appropriate monitoring.

## Case study

### Keep investor protection and compliance in mind when building your company's internal control system!

#### 3. Message to Market Intermediaries

##### Solicitation of Financial Instrument Transaction Contracts

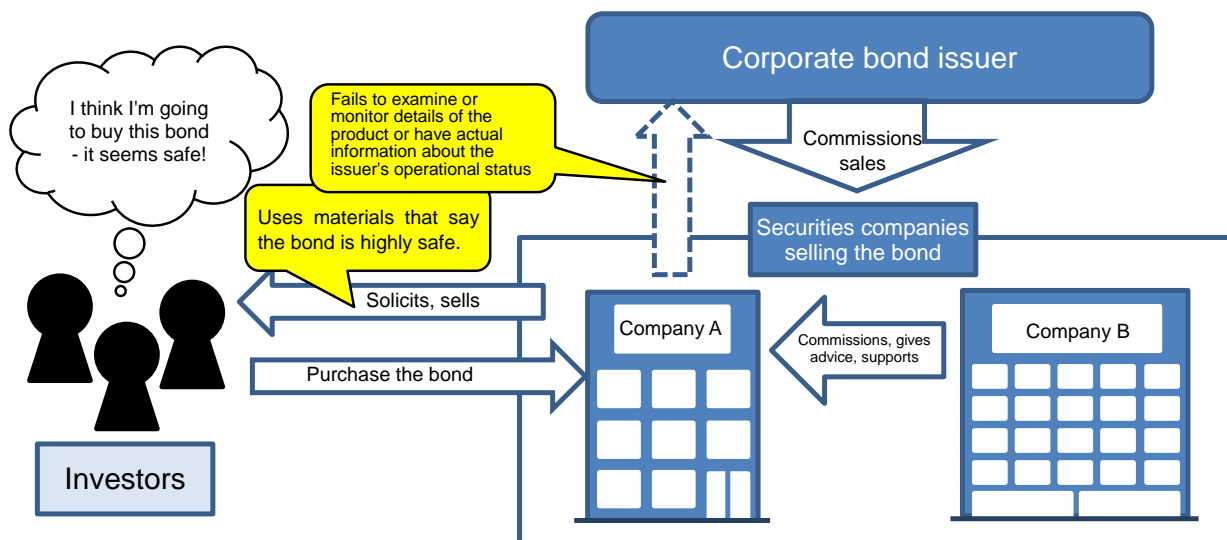
Let's take a look at an actual example where a FIBO engaged in false and misleading representation in soliciting sales of corporate bonds.

Company A, a FIBO, when selling a corporate bond, failed to properly screen or look into the details of the corporate bond, or find out about the issuer's operational status, which is a responsibility of a seller of such products, blindly trusting the assurances of Company B.

As it happened, the issuer was in the red and had a serious solvency issue.

A, however, solicited the sale of the bonds using materials that described the product as highly safe.

The company's act falls under the "act of false representation to customers in relation to solicitation or signing of financial instrument transaction contracts" banned under the FIEA. If investors had correct knowledge of the issuer, they may never have bought such a bond.



Company A's act violates the law, and arose out of a lack of internal control (system to examine or monitor products), which in turn resulted from an excessive focus on securing profits and a lack of awareness of the importance of investor protection and compliance with the law, which a financial instruments business operator is supposed to have. The SESC thinks this was a serious violation.

## 2-5. Investigation of Criminal Cases

### 1. Purpose of Investigation of Criminal Cases

In order to maintain financial and capital markets in which investors and market participants are able to participate with confidence, it is important to establish fairness, transparency and build trust among market participants by responding strictly to material, malicious violations of market rules. For the purpose of uncovering the background to malicious acts that damage the integrity of financial instruments transactions and protection of investors, the SESC was given the special authority to investigate criminal cases in 1992, when the commission was established. Some of the clauses defined under the Act on the Prevention of Transfer of Criminal Proceeds, which regulates global money laundering, are now in the scope of the criminal investigation by the SESC.

### 2. Outcome of Criminal Charges in FY2016

The SESC investigates criminal cases by monitoring not only the primary markets but also the secondary markets in a flexible manner. In FY2016, it filed criminal charges in seven cases, including two cases of suspected insider trading, three cases of suspected market manipulation and two cases of suspected conduct by fraudulent means. Notably, these cases included the unprecedented case for which violation of passing insider information resulted in insider trading (filed criminal charge on Aug. 1, 2016), and another case was filed upon the return to Japan of the suspect who had fled overseas to avoid the criminal investigation (filed criminal charge on Aug. 22 and Oct. 11, 2016).

Case	Date charges were filed	Filed with:
Market manipulation case concerning the shares in YUME NO MACHI SOUZOU IINKAI Co., Ltd.	June 14, 2016	Public Prosecutor of the Tokyo District Public Prosecutor's Office
Insider trading case concerning the shares of Albert Inc.	Aug. 1, 2016	Public Prosecutor of the Tokyo District Public Prosecutor's Office
Market manipulation case concerning the shares of OHT Inc.	Aug. 22, 2016	Public Prosecutor of the Saitama District Public Prosecutor's Office
Market manipulation case concerning the shares of OHT Inc. (2)	Oct. 11, 2016	
Insider trading case concerning the shares of Star Holdings Co., Ltd.	Dec. 7, 2016	Public Prosecutor of the Yokohama District Public Prosecutor's Office

Conducting fraudulent means involving Medical Accounts Receivable Securitized bonds (MARS), by Arts Securities Co., Ltd., and others.	March 6, 2017	Public Prosecutor of the Chiba District Public Prosecutor's Office
Conducting fraudulent means involving Medical Accounts Receivable Securitized bonds (MARS), Arts Securities Co., Ltd., and others. (2)	March 27, 2017	

As the case of the conducting fraudulent means involving Medical Accounts Receivable Securitized bonds (MARS), by Arts Securities Co., Ltd, and others was categorized as especially malicious and investors suffered a lot of losses, its details are described below.

### **3. Typical and Malicious Case of Criminal Charges in FY2016: Conducting fraudulent means involving Medical Accounts Receivable Securitized bonds (MARS) by Arts Securities Co., Ltd., and others**

#### **(1) Case Overview**

The SESC filed criminal charges against two companies and three persons suspected of violation of the FIEA (conducting fraudulent means) with the Chiba District Public Prosecutor's Office on March 6 and 27, 2017. The suspect in this case was the director of one of the suspected corporations named Opti Factor Co., Ltd., which substantially managed the specific purpose company issuing Medical Accounts Receivable Securitized bonds (MARS), and Arts Securities Co., Ltd., which sold MARS and acted as an adviser and instructor of other securities firms which were distributors of MARS. The suspects made employees of the securities firms who did not know the actual performance of MARS, to provide false explanations to other regional securities firms to purchase MARS by using methods such as delivering false investment reports. As a result, MARS were sold to mainly a large number of individual investors across the country.

#### **(2) Developments Leading to Criminal Charges**

Prior to the filing of criminal charges, the SESC recommended administrative actions against Arts Securities to the prime minister and the commissioner of the FSA on Jan. 29, 2016 that the company committed violations of providing customers with false information for the sales of MARS in its inspection. Upon the recommendation from the Kanto Local Finance Bureau, the FSA imposed administrative actions including rescission of registration on the same day. By the end of the year, local finance bureaus imposed administrative actions to a number of regional securities firms that were distributors of MARS bonds

However, the malicious nature of this case went beyond the above administrative actions, the details of which are described below. The SESC decided in this case to file criminal charges against the suspects. As a result of intensive investigation of the assets of MARS bonds, the SESC filed criminal charges against the suspects for conducting fraudulent means in which the suspects made employees solicit customers to purchase MARS bonds which were not highly likely redeemable by using methods such as delivering false investment reports for the violation of the FIEA (Article 197(1) (v), Article 158, Article 207(1) (i) of FIEA, and Article 60 of the Penal Code).

In issuing and selling MARS bonds, which were not highly likely redeemable, the suspects in the conspiracy selling securities firms' customers used methods, such as delivering false investment reports which overstated the purchase amounts of medical accounts receivable underlying assets of MARS and delivering false proposals which stated that the bonds were highly secured financial products. As a result of these fraudulent acts, the suspects sold large amounts of MARS bonds to mainly individual customers. As the bonds were not redeemable, the suspects' act damaged the integrity of the securities market and investors suffered serious losses. The suspects sold MARS bonds to 530 customers and the total sales were 5,706 million yen by using methods such as delivering false investment reports.

### **(3) Comparison with Past Cases of Conducting Fraudulent Means**

This case represents the 20th and 21st in which the SESC filed criminal charges for conducting fraudulent means since the commission was launched in 1992 (excluding cases involving conducting fraudulent means in relation to executing of discretionary investment contracts and spreading rumors). This case differs significantly from previous major cases of conducting fraudulent means that resulted in the filing of criminal charges in recent years, such as the ones involving spreading rumors, conducting fraudulent means and failure to submit reports of possession of a large volume of shares concerning the shares in New Japan Chemical Co., Ltd., and Meiwa Corporation (filed criminal charges on Dec. 14, 2015) and conducting fraudulent means in relation to Ishiyama Gateway Holdings Inc. (filed criminal charges on June 15, 2015). Please refer to the SESC website.

Fraudulent means are fraudulent or unfair ploys and methods that can mislead others. They can take any form as there is no limit as to what methods or formats they are committed. Violations are deemed to constitute conducting fraudulent means when the acts involved are judged to lead investors to make the wrong judgment and undermine the formation of fair prices based on the FIEA provisions on fraudulent means.

One previous example in which the suspects hid the facts and provided false information to sell bonds to customers, as in the present case, is the fraudulent

means case involving Cresvale International Limited that resulted in the filing of criminal charges more than 15 years ago, in which Princeton Notes were sold using methods such as providing false explanations (filed criminal charges on March 21 and 22, 2000). Another precedent example that was similar to the present case, although different law provisions were applied, is the fraudulent means case related to the executing of discretionary investment contracts by AIJ Investment Advisors Co., Ltd. (filed criminal charges on July 9 and 30, Sept. 19 and Oct. 5, 2012). In that case, the company solicited investment managers of pension funds to execute discretionary investment contracts using methods such as providing false investment performance records.

The SESC aims to continue to prevent the recurrence of the same types of cases by taking strict actions against fraudulent means like this case to protect investors.

The SESC appreciates the assistance of Singapore's MAS<sup>12</sup> and the U.S. SEC<sup>13</sup> in the matter.

#### **4. Issues Regarding Investigation of Criminal Cases**

The SESC will take strict actions against such severe and malicious market misconduct by using its full power to conduct criminal investigations and cooperating with relevant authorities. The SESC believes it is important to keep an eye not only on frequently happening misconduct that can be easily categorized into typical types of violations such as insider trading and market manipulation, but also paying careful attention to various market misconduct so that there will be no gap in its market monitoring.

It also believes there is the necessity to flexibly respond to changes in the environment surrounding securities trading. For example, the recent advancement in information technology has made it easy for anyone to use communication equipment to access information, and led to the emergence of new types of communication tools, such as SNS, which were beyond imagination when the FIEA was implemented. In addition, the increase of the number of cross-border transactions has made it inevitably necessary to seek international cooperation in monitoring markets. In order to adjust to various changes in the environment, the SESC aims to make efforts to enhance its market monitoring by upgrading the systems used in criminal investigation and further strengthening its cooperation with overseas authorities.

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<sup>12</sup> Monetary Authority of Singapore

<sup>13</sup> U.S. Securities and Exchange Commission

## 2-6. Enhancing Infrastructure That Supports Surveillance (IT, Human Resources)

### 1. Studying/Analyzing Trends in Market Structural Changes Associated with Advancement in IT

The SESC has researched trends in financial technologies in Japan and abroad and looked into the state of structural change in markets in relation to the increasing introduction of IT and artificial intelligence in securities markets by, for example, interviewing people at financial institutions, IT vendors, audit corporations, etc. Based on what it has learned through such interviews, including trends in the moves to introduce advanced IT and expansion of FinTech use in securities markets, the SESC analyzed their implications on its market surveillance to identify issues needing attention and risks of violations and worked out measures to address them. Reflecting these efforts, it worked out a Medium-Term IT Enhancement Plan that will guide its activity in the medium term (Fig. 2-6-1).

The SESC also interviewed individuals from relevant organizations to find out about the state of FinTech, such as use of blockchain technology, in the securities field and started to engage market insiders in dialogue on using FinTech in monitoring markets.

Based on the results of these interviews and research, the SESC identified issues and risk factors that call for attention, shown below, in regard to changes in market structure driven by advancement in IT and their implications on market surveillance.

- The advancement in blockchain technology and cloud computing has led to dispersion of the locations of data that are subject to investigation and inspection, which would render existing data gathering methods inefficient.
- Due to the advancement in high-frequency and algorithmic trading, the data subject to the SESC's analysis has grown to extremely large amounts, which would make it impossible for the existing trades-surveillance system to process them at a viable speed. The traditional method of manually inspecting data would become simply impossible.

## 2. Issues Calling for Attention in Utilizing IT

### (1) Study of Using Advanced IT for Market Surveillance (RegTech)

With such changes in the external environment in mind, the SESC is studying specific ways to introduce RegTech, or the use of advanced technology to monitor markets, in order for it to respond to changes in market structures and be able to continue to monitor markets effectively. Specifically, it is studying the possibility of using the following:

- ① Technology to screen for and analyze significant information that can impact investment decisions from the enormous amounts of data on the Internet, including information disclosures by listed companies, news, online

publications, and posting on blogs and SNS.

- ②Technology to precisely screen for and analyze order/trades data that raise suspicion of market misconduct from huge amounts of order/trades data.
- ③Technology to detect early signs of inappropriate accounting practices by companies from a wide range of data, including macroeconomic indicators and corporate accounts figures.
- ④Technology to enable a low-cost and smooth way of collecting data for market surveillance (blockchain, Open API, etc.) from market insiders, including financial institutions and self-regulatory organizations.

## **(2) Involving Private Sector Entities in Efforts to Introduce IT (Building a RegTech Ecosystem)**

In order to maintain the integrity and transparency of the markets, it is necessary for the regulatory authorities to engage market insiders, such as financial institutions, in many rounds of dialogue to realize efficient and effective IT investment that will optimize the overall industry (RegTech ecosystem).

The SESC aims to study ways to actively use technology to enable exchange of data smoothly and at low cost (blockchain, Open API, etc.), as well as seek close cooperation between financial institutions and the regulatory authorities in pursuit of introducing advanced IT to realize enhanced market surveillance functions that address more internationalized, complex, sophisticated financial functions so that the integrity and transparency of the overall market can be enhanced (Fig. 2-6-2).



**Fig. 2-6-1: The SESC's IT Strategies**

(Excerpt from the SESC's Medium-Term IT Enhancement Plan)



**Fig. 2-6-2: Creation of a joint public-private RegTech ecosystem**

©Promoting a joint public-private RegTech ecosystem

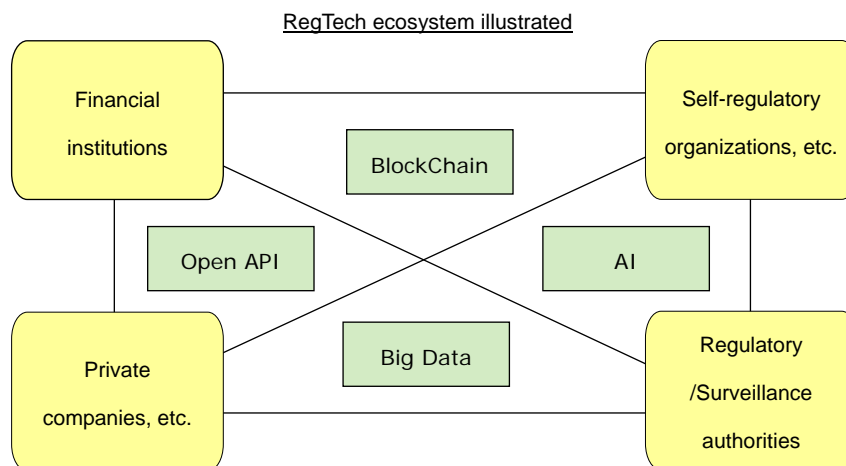
- Efficient, effective IT investment based on dialogue between regulatory/surveillance authorities and market insiders.
- Active dissemination of information at international conferences as part of efforts to contribute to market oversight on the global level.

Purpose:

Enhancing integrity and transparency of markets to support sustainable economic growth by enabling both public and private-sector entities to implement measures to address regulatory/oversight requirements.

Process:

- Seeking efficient and effective IT investment that can bring optimization to the entire industry through repeated dialogue between public and private sector entities, taking into consideration the characteristics of market insiders and business models of financial institutions.
- Actively utilizing technologies that can help reduce IT investment, such as blockchain and Open API.
- Encouraging market insiders to actively use artificial intelligence and big data analysis from the viewpoint of ensuring market integrity and transparency and investor protection.



### (3) Improving digital forensics technology, enhancing system environment

In the past few years, the IT environment that faces the SESC's monitoring has been growing more complex, diversified, sophisticated and growing to process huge amounts of data, as electronic devices, such as smartphones and tablet devices have grown more diversified and sophisticated and the growing use of new IT services, such as cloud services, has made the data that the SESC collects more diversified.

In order to respond to such changes in the environment that surrounds market surveillance, the SESC aims to enhance its system environment for perpetuation of evidence, recovering, analyzing and storing electronic data and further improve its digital forensics technology used to properly protect, perpetuation of evidence, recovering, analyzing electronic devices that are increasingly diversified and

sophisticated.

In FY2016, the SESC has procured additional equipment for digital forensics technology, which it started to introduce in FY2010, to respond to increasingly diversified, sophisticated and large-capacity electronic devices for investigations. Specifically, it introduced a full-text search system aimed at facilitating screening of electronic data by investigative staff as part of the medium-term plan to enhance its system environment. The SESC will continue to enhance its system environment in accordance with the medium-term enhancement plan.

### **3. Staff training**

In FY2016, the SESC strengthened its investigation and inspection by hiring 25 private-sector experts, including individuals with specialized knowledge and experience in securities services, attorneys and certified public accountants, to enhance market surveillance and staff expertise levels. It has conducted such hiring of private-sector talent since 2000, and such individuals totalled 112 as of the end of FY2016.

The SESC also conducts on-the-job and other training programs on various techniques involved in surveillance, including those used in investigation and inspection, and invites external lecturers to speak on the latest trends in the financial/capital markets, as part of efforts to improve staff quality. The lectures have included one on the current usage status of IT in the securities industry such as the latest trends in high frequency trading and algorithmic trading using artificial intelligence, and another on the potential impact of proposed fair-disclosure rules and regulations on high-frequency trading, which are being discussed by the Financial System Council, on the SESC's monitoring activities.

## SESC is monitoring websites such as SNS

### 4. Internet Patrol System

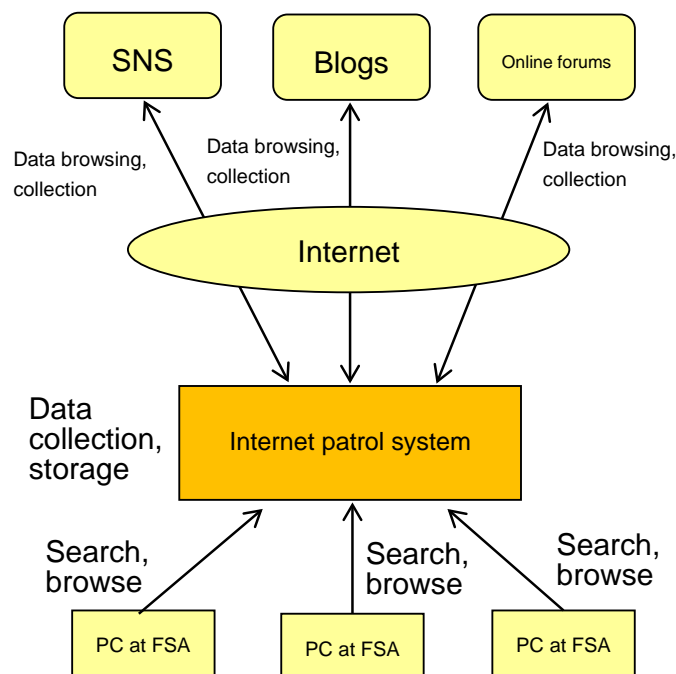
As the world of Information Technology is expanding nowadays, a variety of information regarding financial products are on the Internet.

Regarding such information, we are aware that some of those are likely false information such as those called “Spreading Rumors” which aim to influence the stock prices inappropriately, and another one called “Market Manipulation” in which it appears a few investors are trying to boost the price of particular stocks.

The SESC keeps monitoring those information on the Internet continuously.

For one of our daily monitoring activities, we are using an “Internet Patrol System” where we can retrieve and store data from specific websites, including social networking services, blogs and online forums.

Because the information on the Internet could be updated and/or deleted immediately; therefore, we are using the system to avoid missing important information about market misconduct.



## **2-7. Efforts to Enhance Market Discipline**

### **1. Enhancing Dissemination of Information**

#### **(1) Information Dissemination through Media Organizations, Various Media, Websites, Etc.**

The SESC publishes information through media organizations about cases in which it has filed criminal charges based on its investigation/inspection and on important decisions to change its policy. In releasing information about such cases, it actively responds to requests by newspapers, magazines, TV stations, etc. for cooperation for news stories and submission of articles. The SESC also aims to exchange opinions and engage in dialogue with media insiders to communicate its views and opinions about the significance of the cases and its analysis of them, in order to go beyond just providing information about individual cases.

On its website, the SESC posts information about its activities, such as summaries of cases that involved the filing of criminal charges or administrative action recommendations and lectures and publication of commentaries in the media in a timely manner in an effort to promote understanding of its activities among many market participants. The SESC also sends the latest information posted on its website to registered users with its email newsletter service, publishes a monthly "mail magazine," which explains the significance, characteristics, causes and other details of cases that led to criminal charges or administrative action recommendations, as a way to ensure the details and issues are correctly understood.

In order to further extend the reach and enhance the effectiveness of its information dissemination, the SESC aims to make active efforts, including seeking the opinions of external experts.

#### **(2) Meetings at Local Finance Bureaus**

It is important to make more market participants aware that the SESC is monitoring the market as a way of strengthening market discipline for the goal of maintaining market integrity and transparency and protecting investors. In addition, the expansion of the geographic areas of activities by problem financial service providers and the growing possibility that market misconduct can happen anywhere in the country through the use of the Internet mean that the SESC must extend the reach of its influence to all corners of the country.

It is for this reason that the SESC started to hold securities and exchange surveillance meetings at local finance bureaus in FY2015. Such meetings continued to be held in FY2016 and the SESC's views were conveyed to local staff as part of effort to increase the commission's presence. (Meetings were held on June 3, 2016 at Tokai Local Finance Bureau, Oct 28, 2016 at Kanto Local Finance

Bureau and March 10, 2017 at Hokuriku Local Finance Bureau.)

In relation to the meetings, the SESC exchanged opinions with market insiders from the respective regions and briefed them on the Strategy & Policy to inform them of its activities and views and briefed local news reporters on the purpose of the meetings at local finance bureaus and provided an overview of the SESC's work. Both of these activities were part of efforts to increase the awareness of the fact that the SESC is keeping watch on the market.

The SESC aims to continue such activities to let people know its views and raise awareness of its activities.

## **2. Cooperation with Relevant Offices, Etc.**

### **(1) Collaboration with Self-Regulatory Organizations**

Self-regulatory organizations (financial instruments exchanges and financial instruments firms associations) daily engage in market-monitoring activities, including screening of transactions and management of listings, as well as checks on the appropriateness of their respective members' services. The SESC works closely with these organizations to improve the efficiency and effectiveness of its market monitoring.

The SESC in particular exchanges views with Japan Exchange Regulation and the Japan Securities Dealers Association to promote a common understanding of various problems and issues surrounding the securities markets. In FY2016, it stepped up such exchanges with these organizations by engaging in sharing of views in a timelier manner than before, including discussion of forward-looking themes, including risks associated with current macroeconomic trends.

In addition, the SESC held securities and exchange surveillance meetings at both organizations, where it received briefings on their activities and exchanged views about market monitoring. (Meetings were held on Jan. 27, 2017 at the Japan Securities Dealers Association and on Feb. 21, 2017 at Japan Exchange Regulation.)

As the above efforts are believed to contribute to promoting dialogue and sharing of views between the SESC and self-regulatory organizations as well as promoting market discipline through voluntary industry efforts, the SESC aims to further build cooperation with them by actively exchanging information with them to promote common views on issues.

### **(2) Collaboration with Relevant Authorities (Prosecutors, Police, Consumer Affairs Agency, Etc.)**

When it finds out about malicious service providers, such as nonregistered operators selling fraudulent financial products, or detects involvement of antisocial forces in investigation of market misconduct, the SESC works with the police

authorities by sharing information with them. It also daily works with prosecutors, to whom it files charges on criminal cases, as well as exchanges views with tax authorities, to strengthen cooperation with them.

The SESC has worked to expand and deepen collaboration with these authorities through daily exchange of information and meetings to exchange views and made efforts to share views and information from a wide range of viewpoints and share the know-how related to investigations. In FY2016, it held a meeting to exchange views newly with the Consumer Affairs Agency, where discussions on current activities on both sides and ways to promote effective cooperation between the two authorities were conducted. This expanded the scope of the SESC's collaboration.

In addition, the SESC held meetings of top officials as well as working level staff with regional public prosecutors offices, prefectural police and regional taxation bureaus on various occasions.

In order to reinforce market discipline functions through voluntary efforts by market insiders, the SESC also created opportunities to promote dialogue and share views with market insiders in a proactive manner through speeches and events to exchange views at bar associations and the Japanese Institute of Certified Public Accountants.

### **3. Active Contribution to Efforts to Enhance Market Environment**

In order to establish markets that are fair and highly transparent and ensure investor trust in the markets, market rules must respond to changes in the environment surrounding the markets. For this reason, the SESC can make proposals to the Prime Minister, the FSA Commissioner or the Minister of Finance under the provisions in Article 21 of the Act for Establishment of the Financial Services Agency for measures deemed necessary to ensure fairness in transactions, investor protection and the public interest based on the results of investigation or inspection, when the commission deems it necessary to do so in order to ensure that rules are appropriately changed to reflect the reality of the markets.

In such proposals, the SESC expresses its views on how laws and regulations as well as self-regulatory rules should be changed based on its analysis of the outcomes of investigations and inspections and attempts to have them reflected in policy and measures by administrative agencies and self-regulatory organizations. The proposals made by the SESC are treated as important information when regulatory authorities work out policies.

Specifically, proposals are prepared when the SESC recognizes aspects that need improving in laws, regulations or self-regulatory rules, and explain such aspects and express issues needing consideration regarding how laws and regulations self-regulatory rules should be amended in order to ensure protection of

the public interest, including fairness of transactions and investor protection, and request measures to address them. The SESC has made a total of 24 such proposals since its launch in 1992.

The SESC aims to actively make such proposals in an effort to realize, based on the outcomes of investigations and inspections in accordance with provisions of the FIEA, measures it deems necessary in the policies by the government and self-regulatory organizations.



## 2-8. Contributing to Market Surveillance on a Global Level

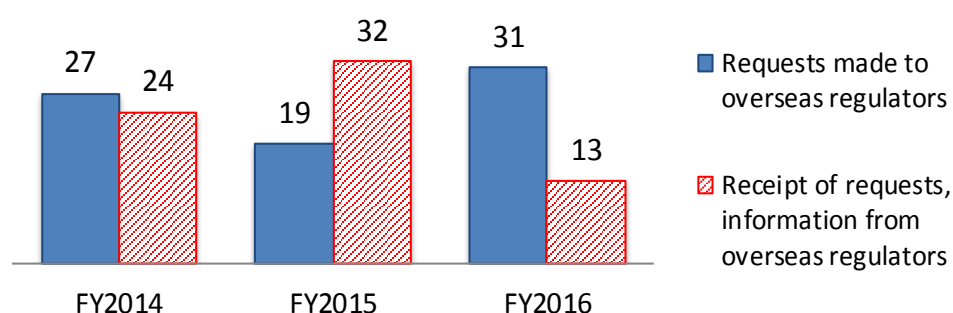
### 1. Collaboration with Overseas Regulators (IOSCO<sup>14</sup>, etc.)

The environment surrounding the global markets is increasingly uncertain as the future of the global economy is unpredictable due to recent moves such as the withdrawal of the U.K. from the European Union (Brexit), etc. Furthermore, markets in our country are now under great influence from macroeconomic trends overseas and specific events as Japanese businesses aggressively expand overseas, and, overseas investments by Japanese institutional investors increase. An increase in overseas investor participation in the domestic market is also driving growth in cross-border transactions and globalization of the markets.

In such a market environment, it is important for the SESC to work more closely with overseas regulators. Toward this end, the SESC has included "Enhanced cooperation with foreign authorities" and "Contribution to international cooperation for market oversight" as part of its medium-term activity policy called Strategy & Policy of the SESC 2017-2019, which was worked out in January 2017.

The SESC has exchanged information with overseas regulators based on the Multilateral Memorandum of Understanding (MMoU) concerning Consultation and Cooperation and the Exchange of Information of IOSCO, and executed legal steps against violations involving cross-border transactions.

**Fig. 2-8-1: Number of information exchange instances based on MMoU, etc.**



The SESC aims to maintain smooth cooperation with overseas regulators by working to develop mutual trust with them and reinforce exchange of information and collaboration in executing investigation, inspection and law enforcement. It is also targeting to take advantage of relevant information about law enforcement moves and legal systems overseas in the market surveillance of Japanese market.

Furthermore, the SESC aims to strengthen efforts to raise issues and share information related to issues regarding international cooperation found through its surveillance activities in bilateral as well as multilateral frameworks such as the

<sup>14</sup> International Organization of Securities Commissions

IOSCO as a way to contribute to market surveillance on the global level.

### **(1) Activities at IOSCO**

The IOSCO is an international organization aiming at coordinating securities regulation efforts on the global level and promoting cooperation between regulators. It comprises 217 organizations of various countries and territories, including 126 ordinary members, 25 associate members and 66 affiliate members. The SESC joined IOSCO as an associate member in October 1993 (the Financial Services Agency is an ordinary member).

IOSCO holds the Annual Conference on the Presidents Committee, the highest decision-making body. In the conference, participants including the top officials of the member organizations report on the current status of their respective securities regulations and discuss issues, and exchange views. In order to conduct proper market surveillance in Japan amid an increase of cross-border transactions in financial/capital markets, it is extremely important for the SESC to deepen its cooperative relationships with overseas regulators by exchanging information and opinions. SESC commissioners regularly participate in the conference for this reason. In FY2016, the Annual Conference was held in Lima in May. SESC then-commissioner Masayuki Yoshida and administrative staff members participated in the conference. In addition, they also held bilateral meetings to exchange opinions with their counterparts of key securities regulators, taking advantage of the valuable opportunity where officials of regulators gathered from various corners of the world. SESC commissioners and senior administrative staff also regularly participate in the Asia-Pacific Regional Committee where they work to particularly discuss regional issues and strengthen their relationship with overseas regulators.

The IOSCO has the IOSCO Board, comprised of regulators from various countries and territories, where key regulatory issues facing international markets are discussed and working solutions are proposed. Under the board are committees discussing individual policy issues. The SESC representatives participate in Committee 4 (C4) where enforcement and the exchange of information are discussed.

In this committee, members also exchange information about securities-related crimes and market misconduct that take advantage of cross-border transactions and discuss ideal forms for cooperation in terms of law enforcement.

The SESC representatives also participate in the Screening Group, which screens applications submitted to the IOSCO administrative office from regulators that applied to become a signatory under the MMoU. In FY2016, the group discussed a proposed revision of the MMoU into an enhanced MMoU as a way to address issues related to law enforcement.

## **(2) Exchanging Views with Overseas Regulators**

The SESC actively exchanges opinions with overseas securities regulators and financial institutions that have global operations, in order to quickly learn about the latest developments in the international financial/capital markets and such securities regulators' efforts to ensure market integrity, as well as to promote understanding of the SESC's efforts. In FY2016, SESC representatives also participated in Asia-Pacific Regulators Dialogue on Market Surveillance in Mumbai in September, where representatives from Asia's market surveillance regulators, including those from Hong Kong's SFC<sup>15</sup>, Singapore's MAS and Australia's ASIC<sup>16</sup>, etc., discussed working-level issues. Furthermore, the SESC exchanged opinions with securities regulators of the United States, Europe and Asia, as well as with globally active financial institutions and international industry organizations.

## **(3) Sending Staff to Overseas Regulators, Participating in Short Training Programs**

The SESC has sent its staff to U.S. SEC, U.S. CFTC<sup>17</sup>, U.K. FSA<sup>18</sup> (current FCA<sup>19</sup>), Hong Kong SFC, Thailand SEC<sup>20</sup> and Singapore MAS to have them learn about surveillance, investigation and inspection methods at overseas regulators and to inform their counterparts about the methods and expertise for surveillance, investigation and inspection in Japan. The SESC has also actively dispatched staff to participate in short-term training programs arranged by IOSCO and overseas regulators.

In addition, the SESC conducts training programs on securities market surveillance and investigation of market misconduct for staffers engaging in securities regulations surveillance among the financial regulatory authority staffers of emerging countries invited to Japan by the Global Financial Partnership Center set up within the FSA.

The SESC is thus working to strengthen the network of financial regulators around the world, share its opinions with overseas counterparts and contribute to enhancing market surveillance functions on the global level through dispatches of its staffers to overseas regulators and exchanges of opinions with overseas counterparts, as well as visits by senior staffers to overseas regulators.

<sup>15</sup> Securities and Futures Commission

<sup>16</sup> Australian Securities and Investments Commission

<sup>17</sup> U.S. Commodity Futures Trading Commission

<sup>18</sup> Financial Services Authority

<sup>19</sup> Financial Conduct Authority

<sup>20</sup> Securities and Exchange Commission, Thailand

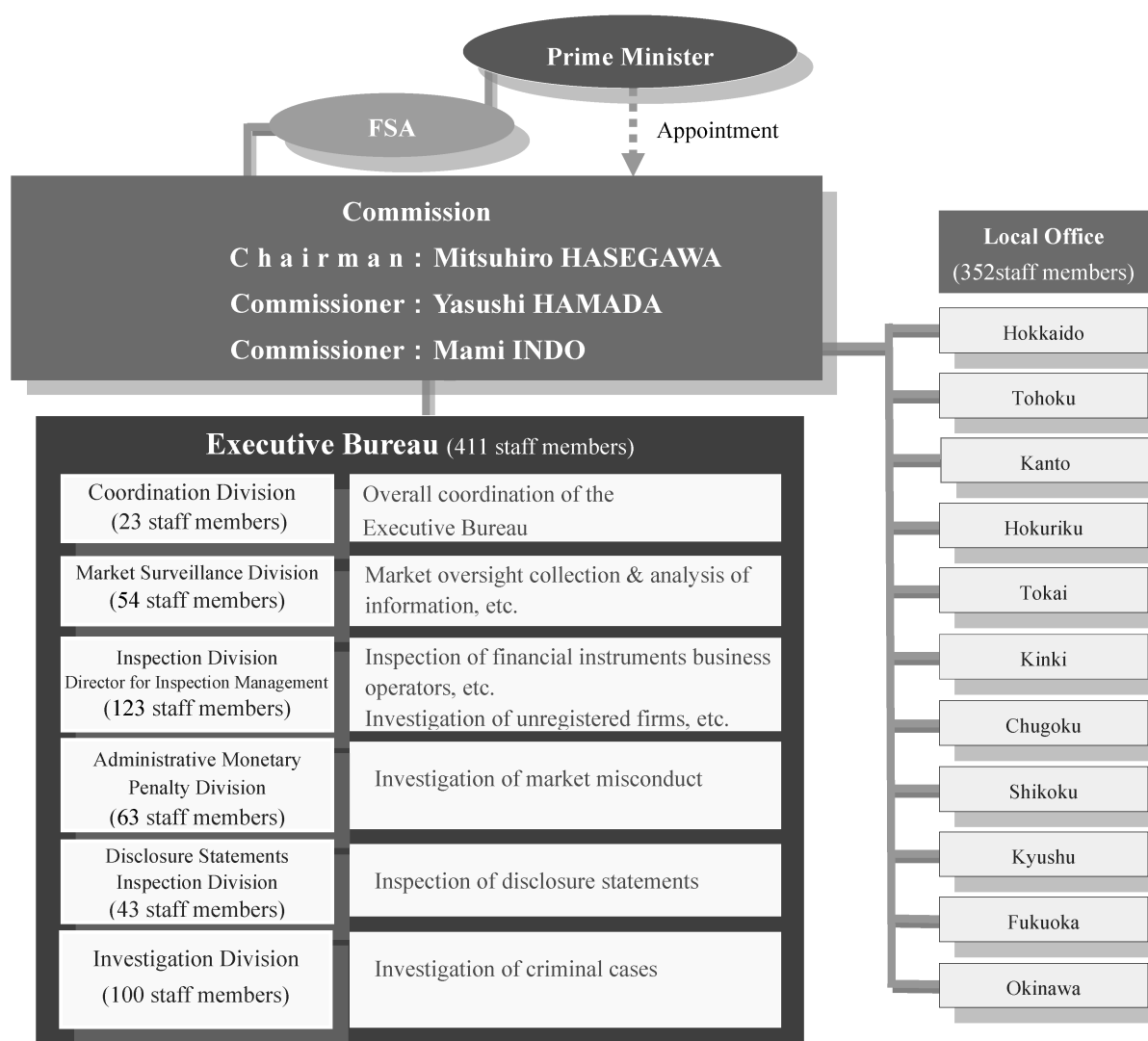


# Appendices



Table 1

## Organization

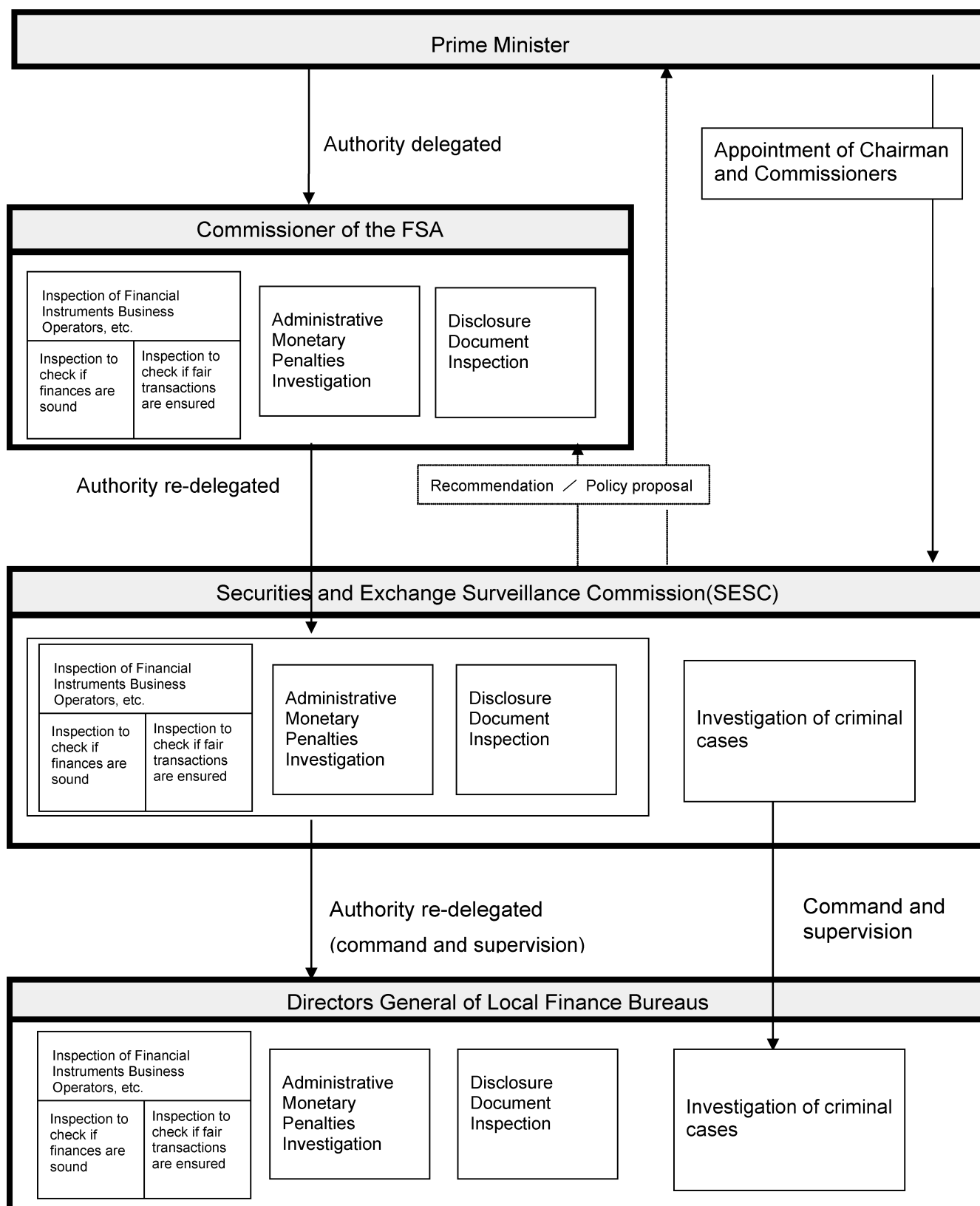


Note1: Staff members of Executive Bureau are quota as at the end of FY2017.

Note2: In July 2006, the SESC was transformed from two divisions (the Coordination and Inspection Division and the Investigation Division) and three offices (the Compliance Inspection Office, the Market Surveillance Office, and the Office of Penalties Investigation and Disclosure Documents Examination under the Coordination and Inspection Division) into five divisions (the Coordination Division, the Market Surveillance Division, the Inspection Division, the Civil Penalties Investigation and Disclosure Documents Inspection Division, and the Investigation Division). Furthermore, in July 2011, the Civil Penalties Investigation and Disclosure Documents Inspection Division was divided into two divisions (the Administrative Monetary Penalty Division and the Disclosure Statements Inspection Division), meaning that the SESC was transformed into six divisions. In August 2011, the Office of Investigation for International Transactions and Related Issues was established within the Administrative Monetary Penalty Division, to investigate transactions, etc. conducted by persons in foreign countries.

**Table 2**

Conceptual Chart of Relationships among the Prime Minister, the Commissioner of the FSA, the SESC, and Directors General of Local Finance Bureaus



(Note 1) For the authority that the SESC delegates to Director General of Local Finance Bureau or the Director of its branch office, the SESC directs and supervises Director General of Local Finance Bureau or the Director of its branch office. (FIEA: Article 194-7 (8))

(Note 2) For an investigation of a criminal offence, the SESC directs and supervises the Director General of a Local Finance Bureau or the Director of its branch office. The SESC may, deeming it necessary for investigating a criminal offence, direct and supervise firsthand an official of a Local Finance Bureaus or the Director of its branch office. (FIEA: Article 224(4) and (5))

(Note 3) The SESC does not delegate authority to the Director-General of local finance bureaus, etc. related to financial instruments business operators etc designated in the following public notices

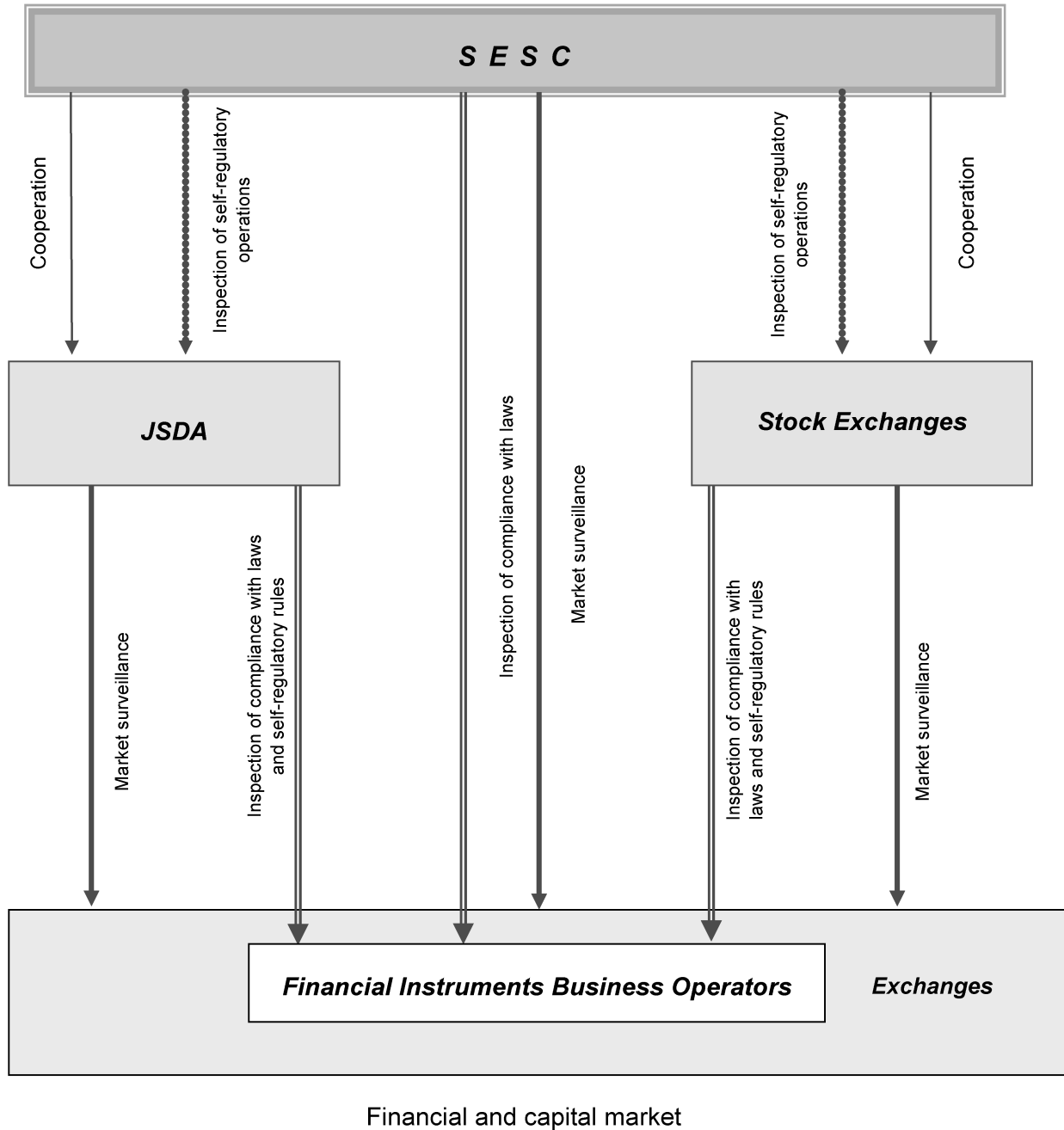
- The public notice to designate a financial instruments business operator, etc. under paragraph 5, Article 44 of the Order for Enforcement of the FIEA and paragraph 2, Article 136 of the Order for Enforcement of Act on Investment Trust and Investment Corporation
- The public notice to designate a financial instruments business operators, etc. under paragraph 6, Article 28 of the Order for Enforcement of Act on the Prevention of Transfer of Crime Proceeds

(Note 4) In addition to the above, filing in court to prohibit or suspend violations based on provisions of FIEA Article 192 Paragraph 1, and its prerequisite investigation authority based on provisions of FIEA Article 187, are delegated from the Commissioner of the FSA to the SESC. The FIEA was amended to enable redelegation of said filings and investigation authority to Director General of Local Finance Bureau or the Director of its branch office.



**Table 3**

**Relationship with Self-Regulatory Organizations**



Note: The same system applies to financial futures.

Table 4

## Activities in Figures

### Table of Summary

Unit: Number of cases

Category \ Fiscal year		1992 to 2011	2012	2013	2014	2015	2016	Total
Criminal charges		157	7	3	6	8	7	188
Recommendations		642	62	70	66	59	91	990
	Recommendations based on securities inspections	442	20	18	16	18	35	549
	Recommendations to pay administrative monetary penalty (market misconduct)	136	32	42	42	35	51	338
	Recommendations to pay administrative monetary penalty (false statements in disclosure statements, etc.)	62	9	9	8	6	5	99
	Recommendations for order to submit revised report, etc.	2	1	1	0	0	0	4
Announcement of results of inspection of persons making notification for business specially permitted for qualified institutional investors		1	13	11	17	17	23	82
Petition for a court injunction, etc., against unregistered business operator or solicitation without the filing of securities registration statements		5	1	2	6	3	1	18
Proposals		22	1	0	1	0	0	24
Securities inspections	Financial instrument businesses operators	2,307	153	222	206	128	37	3,053
	Type I financial instrument businesses operators	1,931	57	69	77	61	16	2,211
	Type II financial instrument businesses operators	44	20	108	72	32	9	285
	Investment management firms Investment advisories/agencies	332	76	45	57	35	12	557
	Registered financial institutions	307	28	9	1	1	0	346
	Persons making notification for business specially permitted for qualified institutional investors	9	21	23	31	30	20	134
	Financial instruments intermediaries	14	9	8	18	19	2	70
	Credit rating agencies	4	3	0	2	0	0	9
	Self-regulatory organizations	23	0	3	3	3	0	32
	Investment corporations	42	0	3	2	1	1	49
	Other	4	0	3	3	3	1	14
	Total	2,710	214	271	266	185	61	3,707
Market oversight		10,619	973	1,043	1,084	1,097	1,142	15,958

## Notes

1. Total number of securities inspections refers to the number of cases that have been started.
2. In addition to the inspections of Type I financial instrument businesses operators (former domestic securities companies) above, Local Finance Bureaus and other organizations conduct inspections of individual branches of those Type I financial instrument businesses operators (former domestic securities companies) that are assigned to the SESC.

## **Monitoring Priorities for Securities Businesses (July 2016 - June 2017)**

### **Introduction**

In 2015, the Financial Services Agency (JFSA or Agency) began issuing a document entitled *Strategic Direction and Priorities* (SDP), which sets forth the JFSA's objectives for the business year (July through June of each year) and its planned implementation approach to achieve those objectives. The SDP for the current business year (July 2016 – June 2017) indicates the Agency's intention to improve the effectiveness and efficiency of its monitoring of financial instruments business operators, and so on. (FIBOs, or securities businesses<sup>1</sup>) by promoting closer cooperation between relevant departments in the JFSA and taking a more seamless approach to on-site and off-site monitoring.

Based on the objectives set forth in the SDP for the current year, the Securities and Exchange Surveillance Commission (SESC) has decided to collaborate more closely with relevant departments of the JFSA in its monitoring activities and to conduct integrated on-site and off-site monitoring of all FIBOs. In addition, it has determined to begin releasing an annual statement entitled *Monitoring Priorities for Securities Businesses* setting forth its general approach to monitoring FIBOs, including its areas of focus in such monitoring, in the coming year. This document replaces the annual *Securities Inspection Policy* documents issued in previous years.

### **1. Monitoring Priorities for Securities Businesses**

#### **(1) Monitoring securities businesses in a changing market**

In view of the SESC's mission to ensure fairness and transparency of the markets and the protection of investors, effective monitoring of securities businesses is essential to promote investors' confidence in the market. An effective monitoring program will encourage FIBOs to have appropriate controls in place to help to ensure that they operate in compliance with relevant laws,

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<sup>1</sup> FIBOs or securities businesses are any businesses that are subject to securities monitoring pursuant to the Financial Instruments and Exchange Act (FIEA), including financial instruments business operators, registered financial institutions, financial instruments intermediary service providers, qualified institutional investor business operators, credit rating agencies, and so on.

regulations, and market rules. Such controls will enhance the ability of firms to perform their function as market intermediaries and gatekeepers.

This monitoring program has taken into account recent developments in the financial markets. FIBOs are facing increasingly complex domestic and global developments that present significant and diverse challenges to their operational and compliance strategies. Specifically, on the domestic front, they face a changing customer base due to the aging population, and a changing investment environment with the introduction of negative interest rates, even as the financial markets have continued to recover from the global financial crisis in 2008. Globally, FIBOs face challenges from the slowdown in growth in Chinese and other emerging economies as well as Brexit. In addition, as with financial firms around the world, the growing threat from cyberattacks, combined with the growth of FinTech, has made it imperative for FIBOs to improve the security and stability of their IT systems.

Meanwhile, the number of securities businesses subject to monitoring by the SESC has increased to approximately 8,000 in total, and these firms offer an increasingly diverse and complex set of services, products, and trading strategies. The SESC's monitoring policy must take into account these industry trends, along with the broader financial market developments described above. In addition, the SESC's monitoring policy will need to take a more proactive approach to monitoring securities businesses regarding requirements of investor protection, including those enacted in amendments to the Financial Instruments and Exchange Act related to the Specially Permitted Businesses for Qualified Institutional Investors that took effect in March 2016.

## (2) Principle approach to monitoring securities businesses

In its monitoring of securities businesses, the SESC has historically focused on reviewing an entity's control environment for legal/regulatory compliance, risk management, and financial soundness, as well as its internal control environment, and it has typically conducted these reviews through on-site monitoring.

In the current business year, the SESC intends to introduce a new monitoring framework that integrates on-site and off-site monitoring of all securities businesses into a seamless process. This process will be based on an off-site risk assessment of the entity's business model, and both the effectiveness of its governance and the appropriateness of its risk management in light of its business model. This approach will evaluate the effectiveness of the entity's

three lines of defense: as the first line of defense, its front-office functions, which are responsible for recognizing and managing risk directly related to their day-to-day operations; as the second line of defense, its risk-management and compliance functions, which oversee the risk management implemented by the front-office functions and verify its effectiveness; and as the third line of defense, its internal audit functions, which are responsible for verifying the controls implemented by front-office, risk-management and compliance functions. The assessment will take into consideration the individual characteristics of each FIBOs, including its business model and the scale of its operations.

The SESC will use the results of this off-site monitoring, together with risk-based analysis, to determine which securities businesses will be subject to on-site monitoring. In carrying out on-site monitoring of a securities business, the SESC will conduct in-depth analyses of the entity's products and transaction strategies to assess its compliance with relevant laws, regulations, and market rules. When these analyses identify a problem, the SESC will go further to identify the root causes of the problem.

## 2. Monitoring strategies for various FIBOs business models

The SESC's monitoring program will implement the specific key approaches set forth in the SDP, while focusing on review of issues that are particularly relevant to different FIBOs business models as described below.

### (1) Large securities business groups (*i.e.*, Japanese securities companies with global operations)

Monitoring of large securities business groups will take a forward-looking perspective, focusing on assessing any changes to, and the sustainability of, the firm's business model; the functioning of its governance functions, risk management, and internal controls; and potential operational risks and other issues affecting the entire group.

Particular areas of focus will include the following:

- whether the front-office functions understand the firm's management strategies and recognize and manage risks accordingly;
- whether the risk-management and compliance functions are performing their role in monitoring front-office functions and verifying that they are appropriately managing risks; and
- whether the internal audit is functioning effectively.

The SESC will also urge securities businesses, where necessary, to take proactive actions against identified issues.

The SESC will also look at the global business activities of these groups,

including their overseas operations, and, by taking their business strategy into consideration, review the sustainability of their business models and the appropriateness of their risk management programs.

Other specific issues for monitoring are:

- appropriate controls regarding the handling of material non-public information to prevent market misconduct;
- an effective trade surveillance system for direct market access (DMA) trading and high frequency algorithmic trading; and
- appropriate due diligence processes in their securities underwriting business that ensure their effective role as intermediaries to facilitate corporate financing.

## (2) Securities companies, other than those described above

Monitoring of these securities companies will focus on changes in their customer base and profit structures, particularly those arising from the aging demographic profile of their customers, and assessing the appropriateness of their business operations in light of their scale and business models. With respect to this, the SESC will review each firm's governance in light of the size of its operations and business model, including whether it has an effective internal audit program that is carried out by an independent division.

With respect to foreign securities firms, in addition to the issues described above, the SESC will also review the Japanese business operations of such firms in light of each firm's business model and the firm's global profit trends. The SESC will also focus on whether such firms have an effective trade surveillance system for DMA trading and high frequency algorithmic trading.

Finally, in the 2015 – 2016 business year, the SESC identified several cases in which local securities companies provided false information to customers in connection with solicitations for investments in bonds. The SESC will monitor whether these firms are sufficiently assessing the risks of the products.

## (3) Foreign currency margin transactions (FX transactions) business operators

The SESC will review whether FX transactions business operators have measures in place to protect investors, such as advance disclosures to customers regarding the risks of such transactions, including possible sudden declines in liquidity leading to the expansion of spreads or potential slippages. In addition, the SESC will monitor whether these business operators have viable measures in place to manage the market risks of foreign exchange transactions.

## (4) Investment management business operators (IMBOs)

The SESC will increase its focus on governance at IMBOs (for example, whether they maintain management and operational independence from sales affiliates, including with respect to managing conflicts of interests and exercising voting rights) and at the funds under their management (for example, a management/control system focused on investors' needs), as well as the status of their internal controls and audits. The SESC intends to develop benchmarks for effective monitoring of these business operators.

(5) Investment advisors/agencies

The SESC intends to review whether investment advisors/agencies are placing advertisements that are misleading to customers or are otherwise soliciting them by deceptive means.

In view of the recently expanding use of robo-advisers in investment advice and asset management services, the SESC will also increase its understanding of how such technologies are being used in the market.

(6) Type II FIBOs

The SESC intends to review Type II FIBOs for the substance of invested businesses and whether money invested in funds is managed appropriately.

(7) Qualified institutional investor business operators (QII business operators)

The SESC will review the substance of invested businesses and whether money invested in funds is managed appropriately, and check whether qualified institutional investors have actually invested money in the funds.

In view of the 2015 amendment to the Financial Instruments and Exchange Act, which restricted the scope of investors, expanded business conduct protections, and provided the JFSA with an authority for administrative actions, the SESC has been focusing on reviewing the operations of QII business operators since March 1, 2016.

(8) Other securities businesses subject to monitoring pursuant to the FIEA

For other securities businesses, including registered financial institutions, credit rating agencies, financial instruments intermediary service providers, and self-regulatory organizations (SROs), the SESC focuses on relevant risks in light of the firm's particular business types.

(9) Unregistered business operators

In order to prevent damage to investors from unregistered business operators, the SESC will strengthen cooperation with the JFSA's Supervisory Bureau, Local Finance Bureaus, and other investigative authorities, and, where

appropriate, exercise its investigative authority to seek injunction in the court to force such firms to cease or suspend activities that violate the FIEA. The SESC will also pursue other measures against such firms, including public disclosure of their names, the names of their representatives, and the nature of their illegal conduct.

### 3. Industry-wide and thematic monitoring priorities

The SESC intends to review the effectiveness of governance, IT systems, risk management, internal audit, and legal/regulatory compliance at securities businesses across all business sectors in light of each firm's scale and business model, and encourage them to address any identified issues.

The SESC will also monitor securities businesses across the industry with a particular focus on their progress in implementing the following:

- customer-first business practices ("Fiduciary Duty");
- cybersecurity;
- trade surveillance of DMA trading and high frequency algorithmic trading, in cooperation with the FSA's monitoring functions.

The SESC will change the focus of its industry-wide and thematic monitoring in response to changes in the market environment.

### 4. On-site monitoring

The SESC will take a seamless approach to on-site monitoring, utilizing risk-based approaches to decide when to conduct on-site monitoring of particular securities businesses with due consideration of various factors, including the results of off-site monitoring. On-site monitoring will focus on items for which review has been deemed necessary.

In carrying out on-site monitoring, the SESC will conduct in-depth analyses of relevant products and transaction strategies, and then review the appropriateness of a FIBOs' business operations. If a problem is identified, the SESC intends to go beyond just identifying violations of laws and regulations and to conduct additional analysis to identify root-causes of any identified problems through review of the firm's management policies and strategy, its governance, and its personnel and remuneration policies. The root-causes analysis should help to encourage securities businesses to develop an effective response to prevent recurrence of similar problems in the future.



## 5. Cooperation with Local Finance Bureaus and other relevant organizations

The SESC and Local Finance Bureaus will enhance their cooperation in monitoring securities businesses. In order to ensure a uniform approach for monitoring, the SESC will support the individual bureaus in planning and implementing off-site monitoring.

In cases where off-site monitoring suggests the operational risk of a FIBO is significant or where a FIBO subject to review falls under the jurisdiction of multiple bureaus, the SESC will conduct on-site monitoring of a FIBO under the jurisdiction of one or more Local Finance Bureaus alone or jointly with them.

The SESC will continue to work closely with SROs, including by sharing perspectives on problems with them to raise the efficiency of the monitoring program and ensure fairness and transparency in the markets. The SESC will also consider the best balance between monitoring by the SESC and audit/examination by SROs and how best to facilitate cooperation between the SESC and the SROs.

## 6. Publication of significant cases

The SESC intends to provide the public with more information about its monitoring of securities business, with specific and straightforward information to help market participants to understand the scope of the review of a securities business and problems that were identified. In particular, the SESC intends to disclose more of the examples of specific cases. The SESC also provides feedback to individual FIBOs, where necessary, by working closely with the JFSA's Supervisory Bureau.

# Strategy & Policy of the SESC 2017-2019

## - Building on a Quarter-Century of Achievement -



### Mission

1. Ensuring market integrity/protection of investors
2. Contributing to sound development of markets
3. Contributing to sustainable economic growth

### SESC's Vision on Market Integrity

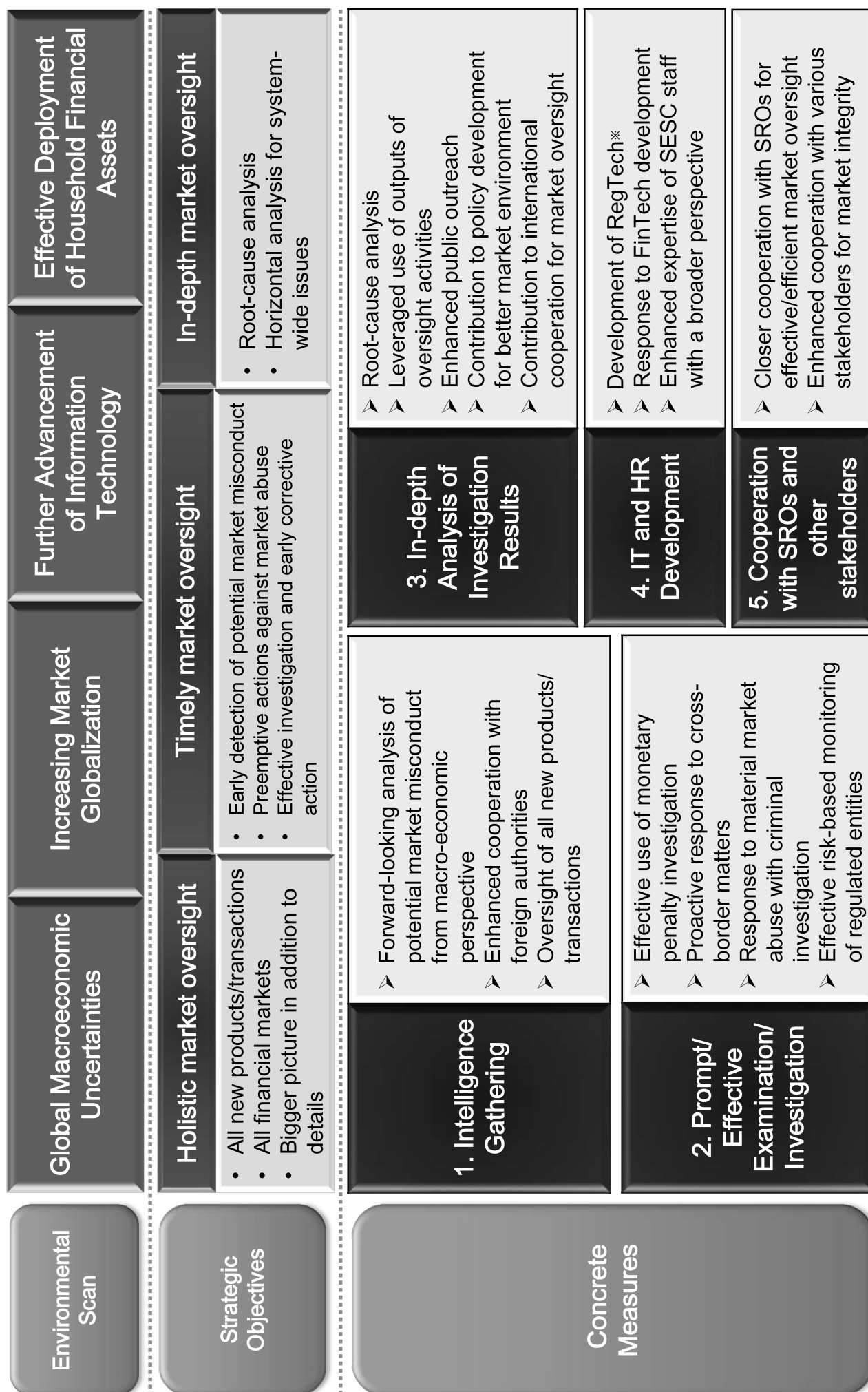
Compliance with rules and trust from all market participants

< Key elements >

1. Proper disclosure by listed companies and issuers
2. Appropriate conduct and practices by market intermediaries
3. Self-discipline by all market participants
4. Effective market oversight with a high degree of professionalism

### Values

<b>Fairness</b> Fair and independent oversight	<b>Accountability</b> Holistic and root-cause analysis coupled with public outreach	<b>Forward-looking Perspective</b> Early detection of signs of market misconduct	<b>Effectiveness and Efficiency</b> Effective use of resources	<b>Strong Collaboration</b> Working closely with SROs and other competent authorities, both domestic and overseas	<b>Commitment to Excellence</b> Committing to achieve highest standards of oversight
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\* RegTech means the use of IT innovation in connection with regulatory and enforcement authority.

## Continuous Review of Market Oversight Approach

## Strategy & Policy of the SESC 2017-2019

### - Building on a Quarter-Century of Achievement -

20/January/2017

Securities and Exchange Surveillance Commission

#### Mission

1. Ensuring market integrity/protection of investors
2. Contributing to sound development of markets
3. Contributing to sustainable economic growth

#### SESC's Vision on Market Integrity

- Compliance with rules and trust from all market participants –

<Key elements>

1. Proper disclosure by listed companies and issuers
2. Appropriate conduct and practices by market intermediaries
3. Self-discipline by all market participants
4. Effective market oversight with a high degree of professionalism

#### Values

1. Fairness:  
Fair and independent oversight
2. Accountability:  
Holistic and root-cause analysis coupled with public outreach
3. Forward-looking Perspective:  
Early detection of signs of market misconduct
4. Effectiveness and Efficiency:  
Effective use of resources
5. Strong Collaboration:  
Working closely with SROs and other competent authorities, both domestic and overseas
6. Commitment to Excellence:  
Committing to achieve highest standards of oversight

## Environmental Scan

The SESC was established in 1992 with the aim of ensuring market integrity and protection of investors. In 2017, the SESC celebrates its 25th anniversary. During this past quarter-century, the SESC has made significant progress in enhancing market integrity and trust from all market participants through various measures; i.e. criminal enforcement against material market abuse which the SESC was empowered from the beginning, as well as additional powers and efforts including a development of examination/investigation for administrative monetary penalty system, an IT and HR development in response to increasingly complex securities markets and transactions; and an enhanced cooperation with competent authorities both domestic and overseas.

In the meantime, the environment surrounding the SESC has significantly changed as follows:

- **Global Macroeconomic Uncertainties:** Uncertainties over the global economy, including possible impact of Brexit, have been increasing.
- **Increasing Market Globalization:** Increasing volume of cross-border transactions and market globalization (e.g., acceleration of overseas business expansion by Japanese companies, increase in overseas investment by Japanese institutional investors, and significant presence of overseas investors in the Japanese market) has made the Japanese market more connected and volatile to the global macro-economic developments and events overseas.
- **Further Advancement of Information Technology:** The market structure has significantly changed with the development of IT technology. Rapid growth of high-speed algorithmic trading and recent development of FinTech<sup>1</sup> could make further changes and innovations in the markets. At the same time, threats of cyber-attacks against the financial system have been growing.

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<sup>1</sup> “FinTech” is a coined word that combines “Finance” and “Technology,” referring mainly to innovative IT-based financial services.

- **Effective Deployment of Household Financial Assets:** In Japan, the Financial Services Agency (FSA) has been taking a number of measures to promote effective deployment of huge financial assets of the Japanese households under the aging population. The SESC contributes to such initiatives through making the markets reliable for investors.

The SESC, at the beginning of its 9th term, has set out the following strategic objectives to achieve its mission under the changing environment, both domestic and overseas. The SESC will continue to make further efforts by effective and efficient use of its expertise and resources of market oversight towards ensuring trust from all the market participants and stakeholders.

## Strategic Objectives

### 1. Holistic market oversight

- **All new products/transactions:**  
Adequate understanding and analysis of risks of all new products/transactions
- **All financial markets:**  
Market-wide monitoring, including Proprietary Trading System (PTS), dark pools<sup>2</sup>, derivatives and primary equity/bond markets, not limited to cash equity markets in the stock exchanges
- **Bigger picture in addition to details:**  
Analysis of entire picture of individual cases, including root causes

### 2. Timely market oversight

- **Early detection of potential market misconduct:**  
Timely detection of signs of market misconduct and response to address them through examination/investigation

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<sup>2</sup> A dark pool commonly means a private electronic stock trading platform, usually created and run by some of securities firms, matching sell orders/buy orders and passing the orders on to off-floor trading markets.

- **Preemptive actions against market abuse:**  
Prevention of misconduct and its expansion through preemptive actions against market abuse
- **Effective investigation and early corrective action:**  
Timely analysis of individual cases and effective remedial measures to fix the problems

### 3. In-depth market oversight

- **Root-cause analysis:**  
Deep-dive identification and analysis of root causes behind market misconducts towards encouraging effective corrective actions to fix and prevent recurrence of the problems
- **Horizontal analysis for system-wide issues:**  
Identification of market-wide structural issues based on horizontal analysis of market misconducts and contribution to policy development for enhanced market integrity

## Concrete Measures

### 1. Intelligence Gathering

- **Forward-looking analysis of potential market misconduct from macro-economic perspective:**
  - In order to prevent market misconduct and to facilitate the early detection of such misconduct in the rapidly changing market environment, the SESC will conduct forward-looking analysis and identification of potential market misconduct from a macro-economic perspective, in addition to conventional ex-post oversight.
  - In particular, the SESC will conduct analysis on emerging impact of macro-economic developments to specific industries and companies in relation to their stock prices and potential market misconducts. The results will be shared within the SESC for the use of examination/investigation.

- **Enhanced cooperation with foreign authorities:**
  - The SESC will enhance working relationships with foreign authorities through mutual trusts, including information-sharing as well as cooperation in examination/investigation and enforcement actions. The SESC will also make effective use of information on enforcement actions and new regulations overseas for its market oversight in Japan.
- **Oversight of all new products/transactions:**
  - The SESC will, through continuous monitoring, cover all products /transactions in the markets including those newly developed as well as those hard to be identified for oversight.

## 2. Prompt/Effective Examination/Investigation

- **Effective use of monetary penalty investigation:**
  - The SESC will conduct prompt and efficient examination/investigation of market misconduct through effective use of monetary penalty investigation in response to the larger and more complex market misconduct.
- **Proactive response to cross-border matters:**
  - The SESC will take proactive enforcement action against cross-border market misconduct by using the information-sharing framework among foreign authorities.
- **Response to material market abuse with criminal investigation:**
  - The SESC will take robust enforcement action against material market abuse by conducting criminal investigation. In addition, the SESC will cooperate with relevant organizations including other law enforcement authorities both in Japan and overseas in order to effectively address the misconduct by deep-dive investigation as well as imposing adequate penalty.
- **Effective risk-based monitoring of regulated entities:**
  - The SESC will conduct seamless on-site/off-site monitoring and effective risk assessment of all financial instruments business operators based on their business models and effectiveness of their governance and risk management.
  - The SESC will conduct on-site monitoring based on risks identified



through off-site monitoring. The on-site monitoring will conduct in-depth review of products and transaction schemes to assess the appropriateness of business operation, and will identify root cause of problems.

### 3. In-depth Analysis of Investigation Results

- **Root-cause analysis:**
  - The SESC will make a recommendation for administrative disciplinary actions against non-compliance with laws and regulations which are identified by inspections and investigations. In addition, the SESC will conduct holistic analysis of the entire picture of the problems and identify their root causes to prevent recurrence of similar issues.
- **Leveraged use of outputs of oversight activities:**
  - The intelligence<sup>3</sup> obtained through individual SESC's inspections and investigations will be shared within the SESC to be accumulated and used for future market oversight activities across the SESC.
- **Enhanced public outreach:**
  - The SESC will enhance its public outreach through providing more information on individual cases including their backgrounds as well as their implications for market discipline.
- **Contribution to policy development for better market environment:**
  - The SESC will identify structural or system-wide issues through horizontal or thematic approach of inspection and investigation and contribute to policy development for better market environment.
- **Contribution to international cooperation for market oversight:**
  - Based on its oversight activities, the SESC will contribute to international cooperation for market oversight by active participation in the policy discussion as well as by collaboration with overseas authorities through bilateral/multilateral information-sharing frameworks, including the IOSCO MMoU.

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<sup>3</sup> "Intelligence" means the information useful not only for specific individual cases but also for other cases.

#### 4. IT and HR Development

- **Development of RegTech:**
  - In response to structural changes including development of IT and AI (Artificial Intelligence) technology in the securities market, the SESC will enhance its IT platform (RegTech<sup>4</sup>) for its market oversight, including the transaction surveillance system.
- **Response to FinTech development:**
  - The SESC will timely respond to new types of transactions and products arising from IT innovation, including FinTech, in order to conduct holistic market oversight.
  - In response to recent advancement of IT and increase of data capacity, the SESC will upgrade its competence on Digital Forensics<sup>5</sup> technology for examination/investigation.
- **Enhanced expertise of SESC staff with a broader perspective:**
  - The SESC will continue to develop further human resources with highly skilled expertise and a broader perspective for market oversight in order to properly achieve its mission.

#### 5. Cooperation with SROs and other stakeholders

- **Closer cooperation with SROs for effective/efficient market oversight:**
  - The SESC expects enhanced role of SROs for market oversight under significant changes in the domestic and overseas market environments through their timely and flexible approach. The SESC will share more information with SROs to support their market oversight function.
  - In response to the increased volume of high-speed algorithmic transactions from overseas, the SESC will enhance its transaction surveillance mechanism in cooperation with SROs. In addition, the SESC will expect enhanced trade surveillance function among broker dealers as market gatekeepers.

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<sup>4</sup> “RegTech” used here means the use of IT innovation in connection with regulatory and enforcement authority.

<sup>5</sup> “Digital Forensics” is a process of analyzing electronic data and preserving evidence.

- In response to a shift to seamless on-site/off-site monitoring of financial instruments business operators, the SESC will also discuss with SROs for better oversight function of their member firms in coordination with the SESC's monitoring.
- **Enhanced cooperation with various stakeholders for market integrity:**
  - In addition to the existing cooperation with SROs and foreign authorities, the SESC will enhance cooperation with various stakeholders for market integrity including investors and other market participants towards market-wide discipline.

## Conclusion

The SESC, celebrating its 25<sup>th</sup> anniversary this year, will move forward to ensure securities market with compliance and trust from all market participants through achieving three objectives set out in this Strategy & Policy: (1) Holistic, (2) Timely, and (3) In-depth market oversight.

This Strategy & Policy was prepared in light of the current economic and financial situation. As the environment surrounding the markets rapidly changes, it is important for the SESC to take proactive responses to new issues and challenges based on PDCA cycle<sup>6</sup>. In order for that, the SESC will conduct continuous review of its market oversight approach by listening to views among external experts.

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<sup>6</sup> "PDCA cycle" is a method for continuous improvement by repeating "Plan, Do, Check, Action" cycle.



## Introduction of the Chairman and Commissioners



### **Chairman Mitsuhiro HASEGAWA**

Mitsuhiro HASEGAWA was appointed Chairman of the SESC in December 2016. Previously, he served as the Chief Public Prosecutor of Nagoya District Public Prosecutors Office and the Superintending Public Prosecutor of Hiroshima High Public Prosecutors Office.



### **Commissioner Yasushi HAMADA**

Yasushi HAMADA was appointed a commissioner of the SESC in December 2016. Previously, he served as the Senior Partner and Director of KPMG AZSA LLC, and the professor of Graduate School of Professional Accountancy, Aoyama Gakuin University.



### **Commissioner Mami INDO**

Mami INDO was appointed a commissioner of the SESC in December 2016. Previously, she served as the Senior Executive Director of Daiwa Institute of Research, Ltd.

Logo of Securities and Exchange Surveillance Commission



\* Note: The two ellipses crossing each other symbolize the securities markets and financial futures markets, which are both subject to our surveillance, the cooperation between the SESC and other domestic authorities concerned, and moreover our relationship with investors. The slogan "for investors, with investors" represents the principle position of the SESC, which was established to protect investors and respect its relationship with them.



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