

Annual Report 2017/2018

Securities and Exchange Surveillance Commission

JAPANESE GOVERNMENT



Annual Report 2017/2018

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

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 Japan's capital markets, protect investors, contribute to their sound development and support sustainable economic growth.

Over 25 years have passed since the SESC's 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, over the years, the SESC expanded and enhanced its authority through the introduction of an 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. Through this expansion and enhancement, the SESC not only filed criminal charges in cases of malicious violation but also contributes to improving the soundness of the markets by actively taking advantage of the authority to conduct inspections and investigations as well as utilizing 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 well versed in the background information of the problems so that we can respond in an appropriate manner.

In response to the changing environment, we, the watchdog of the capital markets, have undergone major changes. While making recommendations for administrative monetary penalty orders and filing criminal charges, the SESC, under a new organization structure launched in 2016, has also worked to achieve its newly added missions "root-cause analysis" and "preemptive actions against market abuse," outlined in the "Strategy & Policy of the SESC 2017-2019" announced in January 2017.

In 2017, the SESC implemented market monitoring with a forward-looking perspective, focusing on risk factors and changes in the market environment in

Japan and abroad through macro-level analysis. With respect to the monitoring of Financial Instruments Business Operators, the SESC has taken measures that include urging operators to establish effective internal control systems. The SESC also strives to resolve issues at an early stage through prompt fact-finding and handling and make recommendations for ordering administrative monetary penalties for market misconduct and violations of disclosure requirements.

Future Challenges

While the world economy remains strong, its future is increasingly uncertain, with heightened geopolitical risks, including the situation with North Korea. However, cross-border transactions are increasing as Japanese companies actively 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 the advancement of information technology. As such, the SESC needs to upgrade its systems for inspection and investigation, while strengthening collaboration with self-regulatory organizations, industry bodies and overseas regulatory authorities as well as with relevant authorities in Japan to develop more in-depth approaches to analysis and carefully monitor market trends, such as new types of financial instruments and trades, thereby implementing seamless market monitoring and responding to market abuse strictly and appropriately. It is also important to engage in dialogue with relevant parties as a way to enhance the integrity of the markets.

This annual report outlines the SESC's activities in FY2017 and explains its views on issues that have been brought to light through the SESC performing its duties pursuant to Article 22 of the Act for Establishment of the Financial Services Agency (Act No. 130 of 1998). We sincerely hope that this report will be read by as many market participants and investors as possible, thereby enhancing their understanding of the SESC's activities and contribute to establishing fair and transparent markets.



July 2018
Mitsuhiro Hasegawa
Chairman
Securities and Exchange Surveillance Commission

SESC's History

Year	Changes in SESC's authority & organization	Key events & activities
1991		Series of securities/financial scandals
1992	SESC established in the Finance Ministry	
1993		Filing of criminal charges: Market manipulation related to Nihon Unisys, Ltd. shares (first criminal charge filed by SESC)
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	Administrative monetary penalty system introduced SESC mandated to exercise investigative authority SESC mandated to exercise inspection authority on disclosure statements Additional inspection authority granted to SESC (inspection of financial soundness, inspection of investment advisors)	Filing of criminal charges: False statements 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	Filing of criminal charges: Spreading of rumors, fraudulent means related to Livedoor Marketing Co., Ltd. shares Filing of criminal charge: 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	Filing of criminal charges, recommendation for administrative monetary penalty: False

		disclosure statements in Securities Report related to Olympus Corporation Recommendation for administrative disciplinary action, filing of criminal charges: AIJ Investment Advisors Co., Ltd. (false notifications, violation of duty of loyalty, etc.)
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. (false notification, 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 Additionally mandated to exercise authority to conduct inspections on specified financial benchmark administrators	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 Recommendation for administrative monetary penalty: False statements in Securities Report related to Toshiba Corporation
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); market manipulation in relation to shares of Stream, Co., Ltd.
2018	Additionally mandated to exercise authority to conduct inspections on high speed trading business operators	Filing of criminal charges: Insider trading related to Toshiba Tec Corporation's shares

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. SESC Activity Summary**1 Overview of activities in Fiscal Year 2017**

In FY 2017 (April 2017 – March 2018), various changes took place in the domestic and global economic environment surrounding Japan's securities markets. Domestically, negative interest rates remained in place. Globally, strong economic recoveries resulted in attempts to make progress toward ending monetary easing. Besides, corporate activities are intensify, which can be seen that corporate earnings in Japan reached record levels, and listed companies expanded their business through merger and acquisitions both domestically and internationally. Despite strong world economy, however, heightening geopolitical risks including the situation in North Korea and other causes have resulted in continuous growth of uncertainties.

Given such circumstances, in FY 2017, the Securities and Exchange Surveillance Commission (SESC) made analysis under a macro-economic approach and conducted market surveillance with a forward-looking perspective, focusing on risk factors and changes in the domestic and global environment. In performing its monitoring and investigation duties, the SESC has not only made recommendations for administrative disciplinary actions against violations of laws and regulations but also looked closely into the root causes to prevent recurrences.

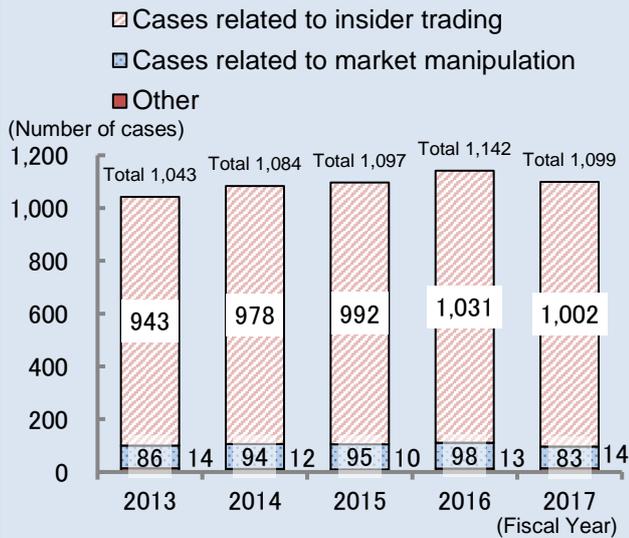
2 Recommendations for administrative monetary penalties and criminal charge filings against market misconduct**(1) Recommendations for administrative monetary penalties and criminal charge filings against market misconduct**

In FY2017, the SESC made recommendations for administrative monetary penalties in 26 marked misconduct cases (21 insider trading and five market manipulation cases) and filed criminal charges against four criminal offense cases.

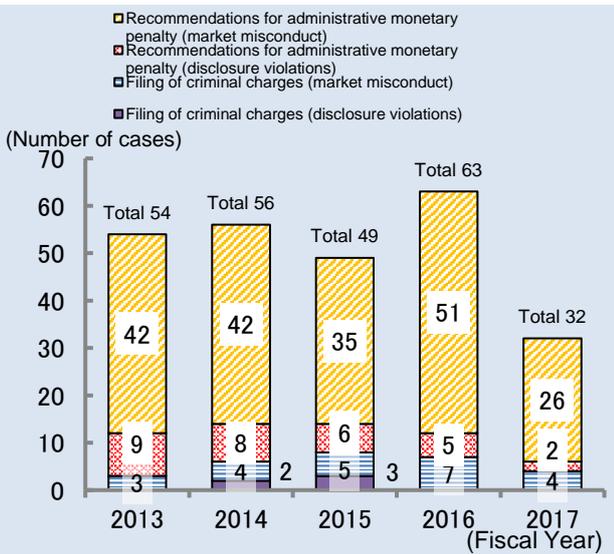
(2) Market oversight leading to recommendations and criminal charges

The total number of cases examined for detecting market misconducts was 1,099 in FY 2017, which marked the fifth consecutive year of over 1,000 examinations.

Market Oversight Examinations



Recommendations and Criminal Charge filings



(3) Trends in market misconduct

With regard to insider trading, those cases involving tender offers and business alliances as material fact continued to constitute a substantial portion of the cases. Underlying such development is the growing needs for corporate reorganization and effective use of precious corporate resources to keep pace with environmental changes where the

economy is becoming increasingly borderless and global. In addition, the SESC made its first recommendations for two categories of material facts, respectively; one involved the occurrence of the cause for delisting (the company would be insolvent for two consecutive years) and the other, disposal of fixed assets (the company sold the land on which its head office was established for debt reduction), both reflecting severe business conditions. In the course of investigations of insider trading, the SESC found issues regarding management of insider information at listed companies. In one case, for example, the material information was not promptly and adequately registered with the section in charge, which led to the absence of proper management of stock transactions.

The scheme of market manipulation became increasingly complicated and sophisticated. For example, in one case, a wrongdoer used multiple brokerage accounts for the purpose of avoiding detection of illegal transactions, while in another, a wrongdoer used “at-market order at closing” for layering or spoofing¹. There also was a case where a wrongdoer used the combination of spoofing orders and wash trades to induce algorithmic trading orders from other investors.

Further, the SESC recognized a case where an institutional investor placed a large

¹ An example of layering or spoofing would be issuing a bulk buy order with low priority in the price range shown

on the exchange information screen without intending to execute the transaction.

amount of sell orders toward the market closing to suppress the price.

(4) Policy going forward

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

The SESC will also publish a case book of administrative monetary penalties, which will provide information on trends and overview of recommendations and identify possible points for improvement regarding the control system to prevent insider trading, in an effort to prevent both recurrences and occurrences of market misconduct.

3 Recommendations against disclosure violations and Detection/Prevention of those

(1) Recommendations against disclosure violations

The SESC made recommendations for administrative monetary penalties regarding two cases of disclosure violations based on the analysis and inspections in FY 2017.

(2) Trends and Causes of the disclosure violations

The summaries of the two cases are described in the following;

- A company's subsidiary reported the fake sales of the TV tuner machines to its audit firm and pretended as if its sales were growing as planned. As a result, the company inadequately avoided to disclose the loss from the revaluation of the TV tuner machines.
- A company disclosed the fake sales of the solar-energy related products from its fictitious operations. As a result, the company overstated its sales.

Those cases involved ineffective internal controls regarding management of subsidiaries and excessive emphasis on sales coupled with disregard for control departments, which suggested underlying governance malfunctions and inadequate awareness of compliance at the companies concerned.

Even among cases where there were no clear indications of disclosure violations, there were cases in which internal review of their own issues were inadequate, raising concerns of potential risks in internal control.

(3) Policy going forward

The SESC will continue to gather information and conduct analysis with a focus on the potential risk of disclosure violations, and aim to deepen its analysis.

Furthermore, the SESC will hold dialogue with the management of listed companies that have committed disclosure violations on the causes of the violation and share awareness

so as to help them build internal systems for proper information disclosure. The SESC will also proactively publish and disseminate details of actual disclosure violations detected in inspections of disclosure statements. Such efforts will collectively prove effective in preventing both recurrences and occurrences of disclosure violations.

4 Seamless on-site/off-site monitoring of FIBOs²

(1) Basic monitoring policy for securities business

Since the 2016 business year³, the SESC has been conducting risk assessments of all FIBOs through off-site monitoring involving analyses of the environment, covering economic and industrial developments, as well as the FIBOs' business models. The SESC has engaged in actions to select FIBOs for on-site monitoring (on-site inspections) based on their respective risk profiles.

In carrying out on-site monitoring, the SESC aims not only to point out legal problems and make recommendations for administrative disciplinary actions, but also to analyze the whole picture, identify root causes of the problems, and thereby lead the

FIBOs to design effective measures that prevent recurrences.

In cases where the SESC identifies necessity to improve business control environments that are yet to materialize as serious problems, the SESC has been engaging in actions to identify them as "issues requiring attention" in its notice of end of inspection addressed to the FIBOs under inspection, sharing the awareness of issues, and urging the FIBOs to establish an effective internal control environment.

(2) Recommendations for administrative disciplinary actions against FIBOs

In FY2017 the SESC made ten recommendations for administrative disciplinary actions against FIBOs.

These cases involved FIBOs that conducted highly problematic business, lacking awareness for legal compliance and investor protection. In one case, a branch manager of a securities firm illegally compensated multiple customers for losses incurred in securities transactions. In another case, a Type II FIBO posted an advertisement on the website that was significantly contradictory to factual reality. There was also a case where an investment advisor/agent provided investment advice with an intention

² In this document, "FIBOs" stands for any business operators that are subject to securities monitoring, including but not limited to Financial Instruments Business Operators, registered financial institutions, financial instruments intermediary service providers,

Qualified Institutional Investor Business Operators ("QII Business Operators"), and credit rating agencies.

³ The 2016 business year refers to the period from July 1, 2016 to June 30, 2017.

to utilize customer transactions for their self-interest.

(3) Policy going forward

While business operators subject to the SESC's monitoring total approximately 7,000 on a gross basis, their size, businesses and products are diverse. Furthermore, there are business operators that are still short of fundamental awareness and controls for compliance and investor protection. The SESC will take such circumstances into consideration and endeavor to accurately identify where risks exist through effective and efficient monitoring.

In cases where the SESC identifies the necessity for early and deeper examinations and concludes further understanding of details to be critical with regard to possible violations of relevant laws and regulations or deficiencies in internal control environment, the SESC will continue to conduct on-site monitoring in a flexible manner.

5 New challenges for the SESC: Efforts to enhance RegTech

(1) Information gathering on developments in financial technologies and authorities' use of information technology in Japan and abroad

Advancements in IT and the convergence of finance and IT (FinTech) in recent years

have brought dramatic changes to the transactions subject to the SESC's monitoring, which may lead to the emergence of new risk factors. Aware of the situation, the SESC has set a "more active use of IT in the market surveillance system (RegTech)" as one of its focus policy areas and continued to gather information on developments in financial technologies in Japan and abroad as well as how IT is used by regulatory authorities and other parties, both domestically and abroad.

(2) Policy going forward

Based on the results of information gathering, the SESC will press ahead with preparations to introduce new market surveillance systems that involve utilization of advanced technologies as the means of responding not only to new technologies in financial markets, such as block chain and AI (artificial intelligence), but also to changes in business processes and business models resulting from the adoption of FinTech, thereby ensuring that market surveillance continues to be effective.

Furthermore, considering that new IT advances, such as the entry by listed companies and FIBOs into the cryptocurrency business and fund procurement via ICOs⁴ (Initial Coin Offerings), could affect markets in various ways, the SESC will also be keeping a close eye on them.

⁴ Generally regarded as a catch-all term for the electronic issuance by companies etc. of tokens in order

to procure fiat currency or virtual currency from the general public.

6 Cooperation with relevant authorities and accountability

(1) Cooperation with relevant authorities

The SESC is working with self-regulatory organizations (e.g., Japan Exchange Regulation and Financial Instruments Firms Associations, hereinafter “SROs”) on a daily basis in surveillance of trades, reviews on the appropriateness of their members’ operations and so on. The SESC further strengthens cooperative relationship with the SROs through periodic dialogues where the parties mutually shared concerns on a timely basis by actively discussing various issues and challenges relating to market surveillance. In FY 2017, the SESC had 16 of such periodic dialogues with SROs, and also met with FIBOs and relevant authorities to exchange views.

In terms of communication with overseas regulators, the SESC participates in multilateral discussions on a variety of topics at IOSCO⁵ and actively engages in exchange of views on a bilateral basis. In addition, the SESC made a total of 20 requests to overseas regulators in relation to investigations into market misconduct using cross-border transactions based on the IOSCO MMoU (Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information) in FY 2017.

(2) Effective dissemination of information

The SESC strives to enhance its external communication by making the information more specific and easier to understand. For each case, the SESC endeavors to provide a clear illustration of the overview, issues identified and significance at various occasions including the publication of individual cases at the time of recommendation, publication of major findings in casebooks on monetary penalties and FIBO monitoring results, as well as contribution of articles and lectures. In FY2017, the SESC spoke at a total of 17 seminars and other occasions to market participants, certified public accountants, attorneys, etc.

⁵ International Organization of Securities Commissions

Chapter 2. Activity Report for Fiscal Year 2017**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 an extensive range of information on overall financial and capital markets for the realization of holistic and proactive market surveillance corresponding to the changing environment surrounding the markets, but also to detect any suspected market misconduct or services by conducting market surveillance of the primary and secondary markets.

For the above reason, the SESC daily receives a wide range of information from ordinary investors, etc., and promptly circulates the information to the relevant divisions within the SESC (or 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 suspected market misconduct, and reports to the relevant divisions in the SESC, if any suspicious transactions are discovered.

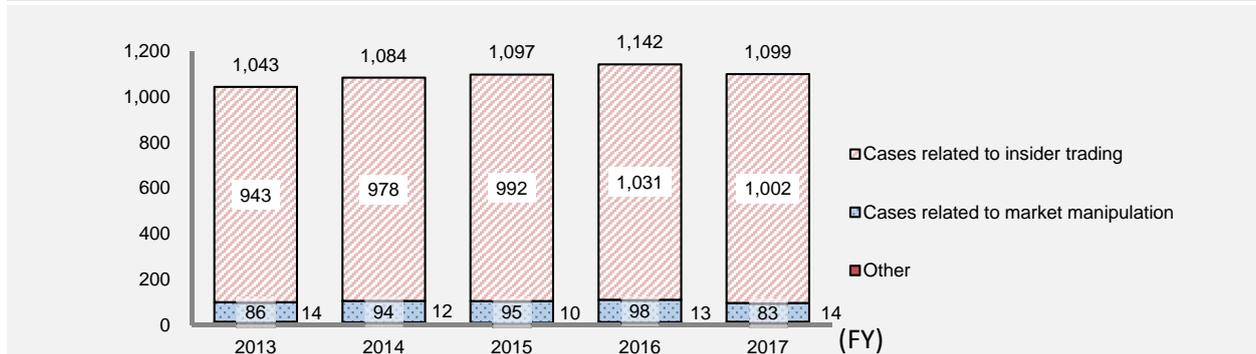
The SESC has closely monitored virtual currency-related businesses operated by listed companies and their affiliated companies, in cooperation with the relevant divisions within the FSA and financial instruments exchanges lately.

The SESC implements effective market surveillance with the aid of the collected information, market trend analysis, and cooperation in market oversight and collaboration among the relevant divisions.

2. Status of market oversight

Changes in the external environment, including macroeconomic trends and advances in information technology, have affected the forms of market misconduct. As market misconduct risk grew amid increased uncertainty in the global economy, the number of transactions the SESC examined to investigate suspicious market conduct was 1,099 in FY2017, the same level as FY2016 and exceeded 1,000 for the fifth consecutive year.

The SESC reviewed 1,099 transactions, consisting of suspected insider trading (1,002), suspected market manipulation (83) and others, including use of fraudulent means and spreading of rumors (14)

Fig. 2-1-1: Number of cases subject to the SESC's market oversight

3. Overview of market monitoring

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

(1) Status of information collection, whistleblowing

(i) Efforts to collect information

Information from ordinary investors and other market participants are candid opinions in markets and can trigger the SESC's investigation and inspection. The SESC believes it is important to collect as much useful information as possible, from as many people as possible.

To this end, in FY2017, the SESC continued its active efforts to collect information, including the launch of an email newsletter service and a twitter account to promote reporting of related information, use of posters and leaflets requesting reporting (distribution of posters, etc. with QR code), revision of the SESC website for the better convenience of providing information to the SESC (Explanatory sections "Flow of information" and "Examples Uses of Information" were added) and the launch of audio assist recorded services for calls outside hours of operation, advising the use of the website as an alternative method of reporting. In FY2017, the SESC received 6,147 reports.

Further, the SESC used the "Pension Investment Hotline", a contact point dedicated to collecting highly useful information on pension fund management and collected information on the operation of fund management companies. Further, the SESC continued to request relevant organizations, such as the Pension Fund Association, to include a link to the hotline on their websites.

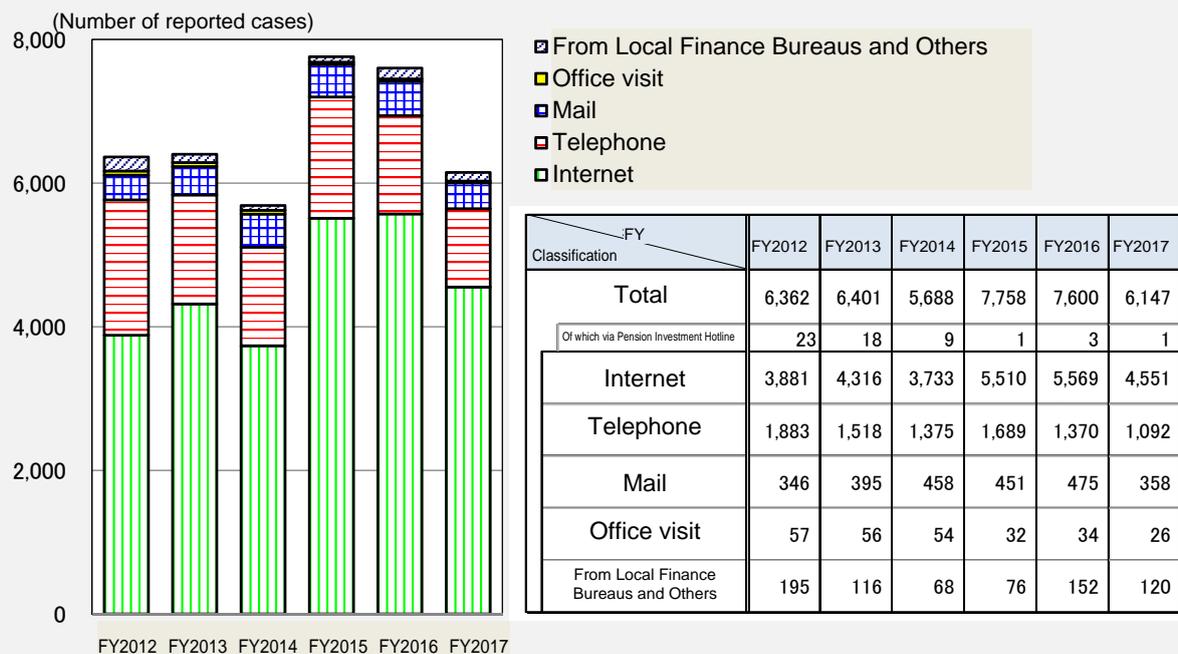
The SESC also provides preparatory consultation to whistleblowers through a dedicated contact point "Contact for Whistleblowing and Assistance" and examines the

contents of the information before formally accepting it. In response to the amendment of the “Guidelines for Administrative Organizations under the Consumer Affairs Agency” (March 2017), the SESC reviewed its whistleblower protection program from the perspective of handling whistleblowing appropriately and improving the transparency of actions taken for the received information, and implemented revised related rules on July 1, 2017. The revisions included (i) the requirement to notify the whistleblower when the investigation is complete, (ii) expansion of the definition of whistleblower and (iii) easing of eligibility requirements as to the veracity of the provided information.

In view of the importance of creating a safe and reliable environment for whistleblowers, the SESC made changes to its website, such as by displaying confidentiality statements to protect whistleblowers’ personal information and adding instructions to those who are not categorized as whistleblowers to provide information through the “Contact for Providing General Information.” Further, to promote the “Contact for Whistleblowing and Assistance”, the SESC requested the Japan Securities Dealers Associations (JSDA), financial instruments exchanges and other related institutions, including the Japan Audit & Supervisory Board Members Association (JASBA) and the Institute of Internal Auditors (Japan office), to insert a link to the contact on their websites.

In FY2017, the SESC received one report of information on which no action was taken as the result of an investigation. The SESC utilizes information that does not fall under the definition of whistleblowing by referring to the Contact for General Information.

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



(ii) Use of collected information

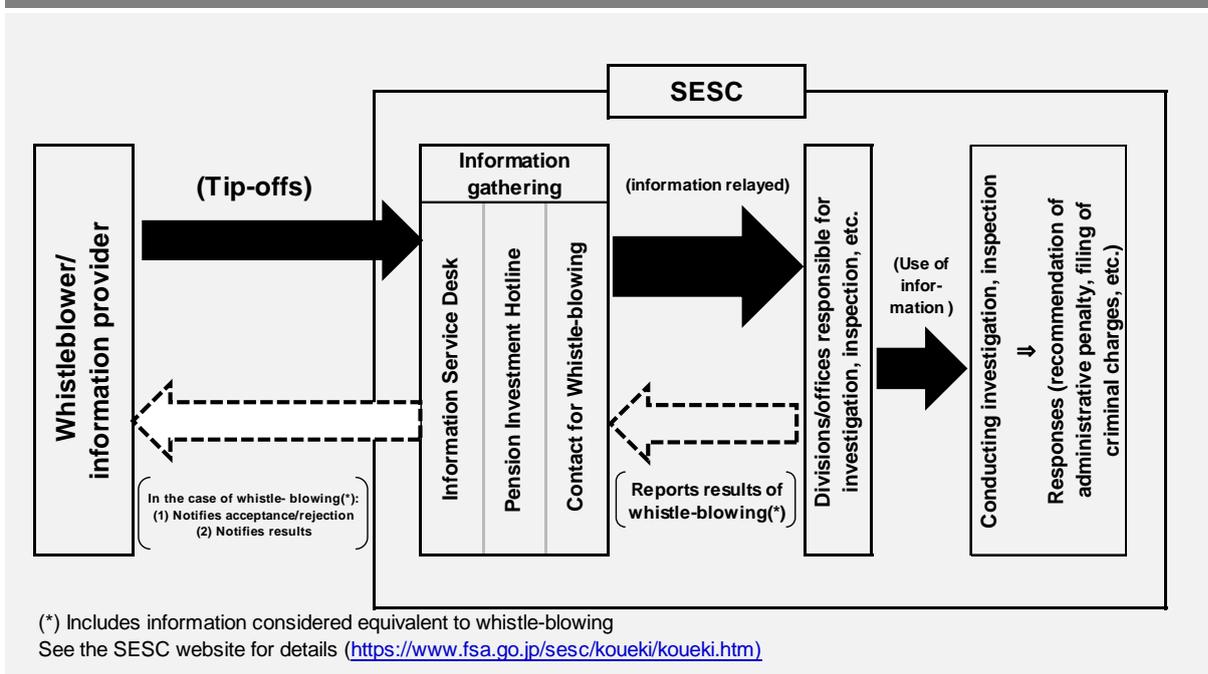
Information/reports on suspected market misconduct are examined at the Information Service Desk and relayed to the responsible divisions in the SESC for investigation, inspection and others, as described below.

For example, a case of insider trading was found based on an investigation triggered by information received about the disposal of Company A's shares by a representative of Company A's subsidiary, knowing Company A's plan to revise its financial performance downward (See Appendix 3-2-4 for other uses of information).

As information/reports on suspected market misconduct are more useful when they are current and specific, the SESC asks readers of this report to refer to Appendix 4 or examples provided on the SESC website⁶ to learn about the details of the two contact points. The SESC will continue its efforts to ensure that a wide range of highly useful information will be provided.

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

Fig. 2-1-3: Flow of information



⁶ Examples of "desired information" on SESC website: <https://www.fsa.go.jp/sesc/watch/example.html> (Japanese version only)

(2) Market trend analysis

In combating cases of "fraudulent finance"⁷, the SESC has utilized information gathered from market participants such as investors and securities companies. The SESC has also enhanced its market monitoring by collecting and analyzing information that covers both primary and secondary markets, in deeper cooperation with directors of the securities and exchange surveillance departments at local financial bureaus, securities auditors and financial instruments exchanges. As a result, some listed companies have been forced to delist or been expelled from the capital market since 2007, due to releasing false information in connection with the issuance of new shares of stock via third-party allocation or stock acquisition rights. However, it is hard to say that there are no problem companies left in the market. There are 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 established a system where information gathered through market monitoring activities can be managed and utilized under a unified system. For FY2017, the SESC decided to increase and thoroughly cumulate collected information to ensure active use of such information in market oversight activities.

Further, given recent developments, such as listed companies or their affiliates entering virtual currency related businesses, the SESC will continue, in cooperation with the FSA's relevant divisions and financial instruments exchanges, to monitor market trends carefully, specifically from the perspective of monitoring listed companies' market misconduct.

(3) Forward-looking analysis

Since July 2016, the SESC has monitored markets with a forward-looking perspective, focusing on risk factors and changes in the environment in Japan and abroad, by analyzing the influences of global changes related to the macro economy, markets, etc. on the financial performance of listed companies, etc.

For FY2017, the SESC conducted analyses of individual companies in 19 sectors which were selected considering economic trends in Japan and abroad, earnings trends, etc. Separately, the SESC selected and analyzed companies that faced deterioration in their financial condition or decelerating growth. In doing so, the SESC collected information through interviews with the assistance of private-sector analysts. Further, the SESC shared the results of the analyses within the SESC and the FSA's relevant divisions.

⁷ "Fraudulent finance" is a series of fraudulent trading practices comprised of inappropriate acts in the primary or secondary market.

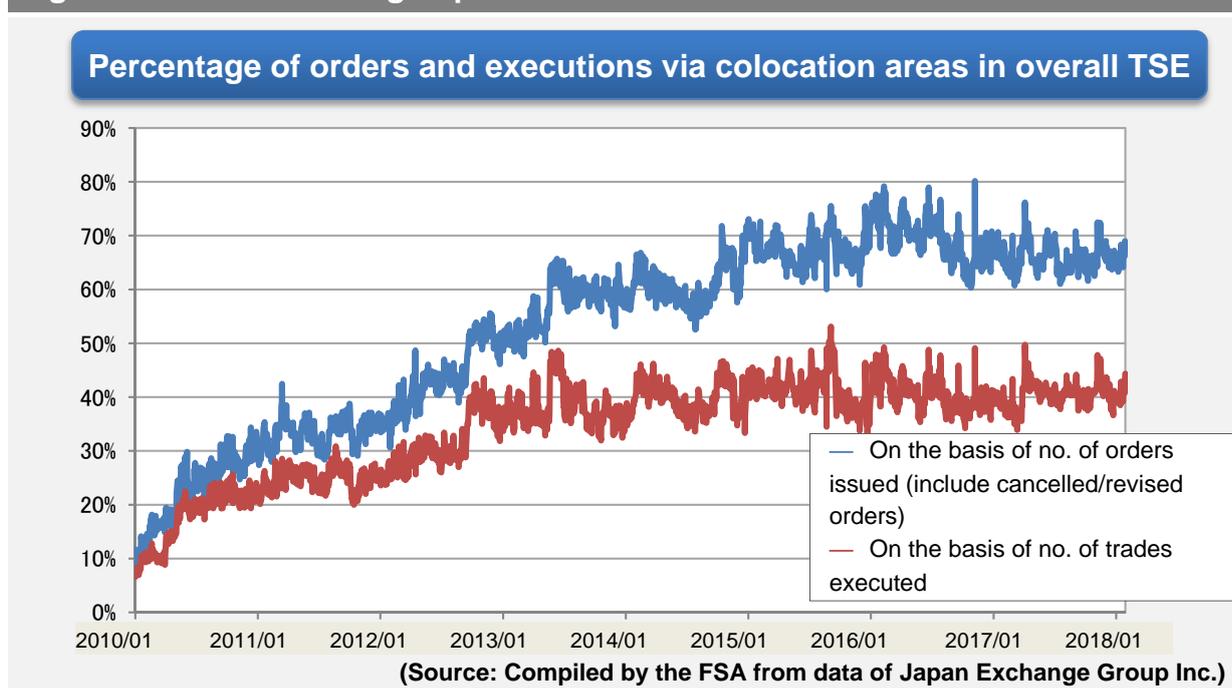
4. Future challenges

(1) Measures as to the introduction of regulations on high speed trading under the revised FIEA

Since the Tokyo Stock Exchange has begun colocation services from 2010, the share of transactions via colocation areas⁸ has increased significantly in terms of both orders and executions. This was evidenced by an increase in the share of algorithmic high speed transactions (See Fig. 2-1-4).

Under such circumstances, the Act on Partial Amendment to the FIEA which includes the introduction of regulations on HST was implemented in April 2018. The SESC, based on information provided by financial instruments exchanges, etc., will clarify the characteristics of orders and executions by HST operators and analyze the behavior of stock prices as well, while the SESC will share information and exchange opinions on HST operators with the FSA's relevant divisions and financial instruments exchanges.

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



(2) Sophistication of analysis from a forward-looking perspective

The SESC will conduct analysis in a forward-looking manner by maintaining in-depth relationships with private-sector analysts, etc., acquiring a wide range of information on

⁸ 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.

potential risks associated with uncertainties in the global economy in a timely manner and by enhancing cooperation among the relevant divisions.

(3) Use of information technology

Driven by the growing share of HST in the market, the volume of data regarding orders and executions has increased substantially. Thus, the capability to verify and analyze large volumes of data is essential to conduct market misconduct examinations efficiently and effectively. Further, to conduct seamless market surveillance amidst the increasing complexity and variety of transactions, it is necessary to have a mechanism in place that can collect and search for the required data quickly. The SESC will resolve these issues by further utilization of information technology.

(4) Promotion to increase receipt of information and whistleblowing

To promote reporting of useful information to the SESC, the SESC will endeavor to increase the level of public recognition regarding the "Contact for Whistleblowing and Assistance", such as by identifying new counterparties to display posters and distribute leaflets for the SESC. Further, for the better convenience of providing information to the SESC, the SESC plans to improve input screens on the website and investigate the possibility of setting up a website dedicated to the provision of information via smartphone.

2-2 Monitoring of financial instruments business operators

1. Purpose of monitoring securities businesses

It is the SESC's mission to ensure the fairness and transparency of the markets, protect investors and contribute to the sound development of markets and sustainable economic growth, thereby maintaining investors' confidence in financial markets.

To accomplish the mission, the SESC accurately grasps the operation and financial status of Financial Instruments Business Operators ("FIBOs"), through seamless on-site and off-site monitoring. If any problem is found, the SESC, as necessary, recommends that the Prime Minister and the FSA commissioner take appropriate measures or provides necessary information to the supervisory departments, thereby urging FIBOs to perform their function as market intermediaries and gatekeepers appropriately in compliance with laws, regulations and market rules based on self-discipline.

2. Changes in environment surrounding financial instruments business operators

The Japanese stock market has risen steadily since 2013. However, the external environment surrounding the market has changed in various aspects, including the continued aging of the population and the government's decision to continue its negative interest policy, as well as rising geopolitical risks fueled by trade issues among other countries and regions. Changes for FIBOs included the March 2017 release of the FSA's "Principles for Customer-Oriented Business Conduct (fiduciary duty)" (hereinafter referred to as the "FD Principles") which was adopted by FIBOs (mainly securities companies) and other financial institutions.

Under such changes, it is important that FIBOs manage risk appropriately and ensure that profits are generated steadily, through the expansion and enhancement of their customer base by gaining confidence with products and services that meet the true needs/interests of customers. It is the SESC's mission to support the Japanese public's stable asset formation and expand the nation's investor base by facilitating the creation of markets 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 platforms.

3. Achievements of securities business monitoring (risk awareness, etc.)

The number of FIBOs subject to the SESC's monitoring is approximately 7,000 in total, and their size, service details and product offerings vary widely. Some of these FIBOs have not had adequate awareness towards and systems for legal and regulatory compliance and

investor protection. As such, it is important to monitor them efficiently and effectively to promptly identify risks for given characteristics of FIBOs considering macro-analysis of economic and business trends (See figure 2-2-1).

In July 2016, the SESC started integrated on-site and off-site monitoring of all FIBOs and assessed risks based on their business type, size and other characteristics. In assessing risks, the SESC closely examined the business operations of each FIBO, while conducting peer reviews of major securities companies focusing on governance, IT system management, risk management, internal audits, etc.

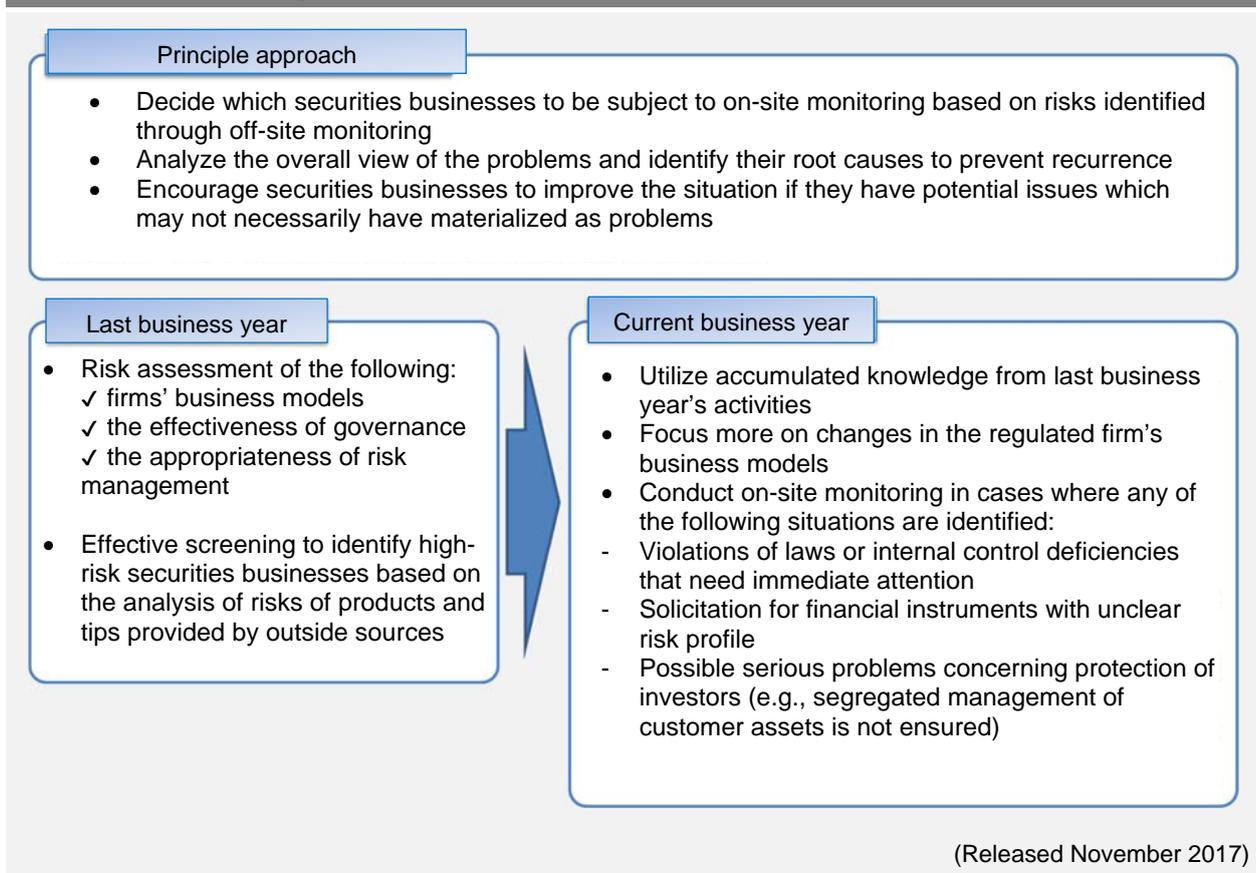
Based on the result of the risk assessment above, the SESC selected the FIBOs to be subject to on-site monitoring using multi-faceted risk evaluation. In on-site monitoring, the SESC conducted in-depth analysis of the FIBOs' products and trading schemes and examined the appropriateness of their business operations. When problems were detected, the SESC further looked into their root causes.

Fig. 2-2-1 FIBOs subject to securities business monitoring



(Note) Data as of March 2018

Fig. 2-2-2 Summary points from monitoring priorities for securities businesses for 2017 business year⁹



(1) Securities companies

In the 2016 business year, the SESC conducted risk assessment of securities companies, focusing on the appropriateness of their business models and governance and risk management, based on the “three lines of defense” concept¹⁰, taking into consideration the business, size and other characteristics of securities companies. This was followed by monitoring through dialogue, mainly regarding the first line of defense (front office functions) and the third line of defense (internal audit functions).

In the 2017 business year, continuing the ongoing approach as above, the SESC conducted monitoring focusing mainly on the following perspectives.

(i) Second line of defense (compliance and risk management functions)

⁹ The 2017 business year refers to the period from July 1, 2017 to June 30, 2018.

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

The SESC conducted monitoring on the effectiveness and appropriateness of securities companies' second line of defense, particularly whether they checked and controlled changes in the business model and product offering in a timely manner.

The SESC found in the monitoring that some large securities companies made continuous efforts to maintain an effective system by utilizing the PDCA cycle under a compliance program, but others failed to align their business operations to changes including taking appropriate actions until serious events (accidents and complaints) occurred and risks were identified.

(ii) Customer-oriented business operation

From the perspective of customer-oriented business operation, the SESC monitored whether each company developed a policy based on the FD Principles and whether its sales personnel complied with its policy.

The SESC found that while most securities companies had publicly announced their commitment to the FD Principles and their policies (226 companies as of March 2018), only a fraction of these companies had publicly disclosed their key performance indicators (KPIs). Furthermore, only a fraction of companies' management teams were proactively involved in developing specific policies and measures and motivating sales personnel to comply with customer-oriented business operation.

Although trends such as longer holding periods for investment trusts and growth in managed assets were seen, the concept of customer-oriented business operation is not widely accepted and seems to have just started to be acknowledged in terms of structuring, selling and soliciting financial instruments in the best interests of customers and in a manner aligned with customer attributes.

The SESC will continue to urge companies to operate their business based on fiduciary duty ("FD") through dialogue-based monitoring, including ensuring the sustainability of business models.

The following table shows issues and risks related to business operations by size and business of securities companies which were identified in the monitoring.

Issues and risks related to business operation

Large securities companies

- FD Principles are not fully practiced in retail service
- There is room for improving the compliance system including explanation of complex and high-risk financial instruments, and risk management of overseas operations

Bank-affiliated large securities companies	Potential risks regarding conflicts of interest and the abuse of dominant bargaining position
Foreign securities companies	Risks in making judgment regarding the suitability of the derivatives offered for the investment needs of customers in Japan
Online brokerages	Risks related to the diversification of operational tasks
Local securities companies	Risks related to the uncertainty of business operations arising from excessive reliance on equity sales as the source of revenue, given an aging customer base, customers losing interest, etc.

Furthermore, in light of an FX dealer's massive information leak caused by a cyberattack, the SESC conducted a fact-finding survey on cyber-security measures taken by securities companies and FX dealers.

It was found in the survey that some small-size securities companies and FX dealers were not well-prepared for cyber-security issues due to managers' lack of awareness. The SESC provided the results of the analysis to them and urged them to take adequate measures.

Of the 21 securities companies that were subjected to on-site monitoring in FY2017, the SESC notified 19 about their problems found in the monitoring, and made recommendations for administrative disciplinary actions on three that committed serious breaches of laws and regulations.

Key Cases:

Company name	Date of recommendation	Description
Yutaka Securities Co., Ltd.	October 13, 2017	To compensate for losses suffered from stock trading for a customer, a branch manager deposited in the customer's account about 4.65 million yen from his personal finances. The branch manager also executed share trades frequently for his own speculative

		profit, using customers' accounts and money borrowed from a customer.
Iwai Cosmo Securities Co., Ltd.	December 12, 2017	Sales staff members solicited customers for purchasing shares using information such as share ratings and share target prices from unpublished analyst reports. The company also disseminated the unpublished ratings information, etc. to all sales staff using an internal announcing system and permitted them to solicit customers while using the information. The Company's handling of the information in the analyst reports was completely inappropriate.

(2) Investment management business operators

In monitoring investment management business operators, the SESC focused on large operators' FD-based business operation, conflict of interest management, liquidity management, etc.

All operators that were subject to monitoring had adopted the FD Principles and disclosed their policies, etc. However, for KPIs, they are still in the process of discussion to set indicators which can measure the progress towards FD-based business operations objectively. The SESC will seek the possibility to make comparisons of KPIs disclosed by investment management business operators, while continuing the monitoring of their status of establishing FD-based business operations.

For conflict of interest management, most investment management business operators have established internal rules and verification and reporting systems. Furthermore, some operators upgraded their systems in line with their efforts for FD-based business operations.

(3) Type II financial instruments business operators

The SESC conducted off-site monitoring focusing on the investment targets, dividend yield, etc. of funds, and then conducted on-site monitoring of the operators considered to be carrying high risk based on the results of off-site monitoring. The SESC found that some operators placed misleading advertisements on their websites.

Of the six operators that were subjected to on-site monitoring in FY2017, the SESC notified five about problems found in the monitoring and made recommendations for administrative disciplinary actions on four that had committed serious breaches of laws and regulations.

Key Cases:

Company name	Date of recommendation	Description
Crowd Securities Japan, Inc.	June 2, 2017	The company displayed false advertisements on its website, including indications that it is unlikely that investors would suffer any loss and that the company would refund brokerage fees, etc. with no intention of doing so.
Lucky Bank Investment Co., Ltd.	February 20, 2018	The company made a misleading claim to make investors believe that it goes through a prudent process when screening borrowers of underlying business loans in a fund. It also gave a misleading description on collateral valuation by listing property prices that should not have been publicly disclosed.

(4) Investment advisors/agencies

The SESC monitored investment advisors/agencies with a particular focus on representations on their websites and then conducted on-site monitoring on the advisors/agencies considered to carry high risk. The SESC found that some investment advisors/agencies provided investment advice in pursuit of their own interests, taking advantage of customers' transactions.

Of the four investment advisors/agencies that went through on-site monitoring in FY2017, the SESC notified three about their problems found in the monitoring and made recommendations for administrative disciplinary actions on one that had committed to serious breaches of laws and regulations.

Key Cases:

Company name	Date of recommendation	Description
Growth Advisors Co., Ltd.	February 23, 2018	The Company's officers and employees engaged in self-dealing and made profits for themselves by advising customers to purchase shares at a specified timing for boosting the prices and selling off shares they had purchased. In addition, as the company failed to establish a management system to obtain information and manage share trading by officers and employees, it was not aware of such violations for a long time.

(5) Petitions for court injunction against violations of the FIEA

To prevent damage to investors from fraud caused by unregistered business operators, the SESC takes actions against unregistered business operator rigorously by utilizing its investigative authority in relation to filing petitions for court injunctions to prohibit or suspend the violations in cooperation with the FSA Supervisory Bureau, Local Finance Bureaus and investigating authorities. As necessary, the SESC may publicly disclose the name of the unregistered business operator, the name of the representative, and a description of the legal and regulatory violations.

Key Case:

Defendant	Date of petition (name of court)	Description	Issue date
JG-company Co., Ltd., Master Co., Ltd., S&F Co., Ltd., and three individuals	March 2, 2018 (Tokyo District Court)	The companies and their respective managers engaged in investment advisory business without statutory registration. They opened numerous websites for dummy corporations and solicited retail investors who registered	March 29, 2018 (Tokyo District Court)

		<p>for free membership for entering into an investment advisory contract by phone and email. They also engaged in Type I Financial Instruments Business, such as introducing overseas FX dealers to customers who purchased FX automated trading software and receiving commissions from the FX dealers based on the transaction volume of the customers, without statutory registration.</p>	
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(6) Issues require attention

In conducting on-site monitoring, it is important that the SESC not only points out legal problems and makes recommendations for administrative disciplinary actions, but also analyzes the overall view of the problems to identify their root causes, so that FIBOs can address them and prevent recurrences of the problems. .

As such, when identifying the need for improvement of management systems or other potential issues which may not necessarily have become materialized problems, the SESC has shared the findings with the subjects of the on-site monitoring and has encouraged them to build an effective internal control system or address their issues.

Example cases:

(i) Improvement of support to outside directors

Management has not had any specific discussion on providing support for outside directors. Thus, agenda items for a board of directors meeting are determined at the management meeting in which the outside directors do not participate and informed to them only on the day of the meeting, leaving no time for outside directors to give full consideration to the agenda items and the business direction that the agenda items are based upon. Under such circumstances, outside directors' opinions pertinent to the agenda items are not expected to be incorporated in the decision making appropriately.

(ii) Prevention measures against recurrences of problematic conduct in securities business, etc.

In a department consisting of staff on secondment from the parent bank, etc. and regular employees, basic errors are frequently made by secondment staff who lack

experience and knowledge of securities business operations. However, due to the limited number of employees with knowledge and experience in securities sales and compliance, the internal control department has not conducted analysis and verification on causes of problematic conduct in securities business and the tendency of individuals causing accidents, thereby failing to understand the situation appropriately.

(iii) Establishment of effective internal audit system

Given significant changes in sales strategies and styles, a risk-based audit approach, including the evaluation of risks inherent to business operations and the verification and evaluation of the management system over such evaluation activities, has become increasingly important. However, the company has conducted conventional-style internal audit, which mainly inspected the adequacy of branch offices' administrative process, and its internal audit system itself has not been reviewed. For a viable third line of defense, it is necessary to establish an effective audit system, including risk-based audit planning aligned with changes in the business model, evaluation of the effectiveness of internal control, etc.

4. Challenges for the future

(1) Enhancing monitoring of securities business

The number of operators subject to monitoring by the SESC totaled approximately 7,000 after the enforcement of the FIEA, and their scale of operations, type of service and products are diverse. Furthermore, they include operators that do not fully establish basic controls to comply with relevant laws and regulations in order to protect investors. To conduct monitoring of these operators efficiently and effectively, the SESC has integrated on-site and off-site monitoring of FIBOs since July 2016.

In conducting monitoring, the SESC has focused on verifying the appropriateness of governance and risk management. Going forward, the SESC plans to upgrade its approach so that challenges and problems facing FIBOs are identified earlier through risk assessment based on analysis of the business environment covering economic and industrial trends.

The SESC also plans to review its monitoring approaches in light of the FSA's policy document "JFSA's supervisory approaches (replacing checklists with engagement)" to be published in FY2018.

(2) Enhancing feedback

In conducting monitoring, the SESC has focused on finding and exposing violations of laws and regulations. Going forward, the SESC will also identify and analyze causes of

recognized issues and give feedback to encourage business operators to develop effective preventive measures.

Furthermore, the SESC will share feedback on the results of off-site monitoring that will contribute to encouraging FIBOs to operate business appropriately, such as challenges common across the sector and best practices.

(3) Adapting monitoring system to changing regulatory environment

In response to the enforcement of the Act for the Partial Revision of the FIEA in April 2018, which included the introduction of regulations on operators performing High Speed Trading (“HST”), the SESC will verify the appropriateness of business operations at securities companies undertaking HST business in cooperation with the supervisory departments.

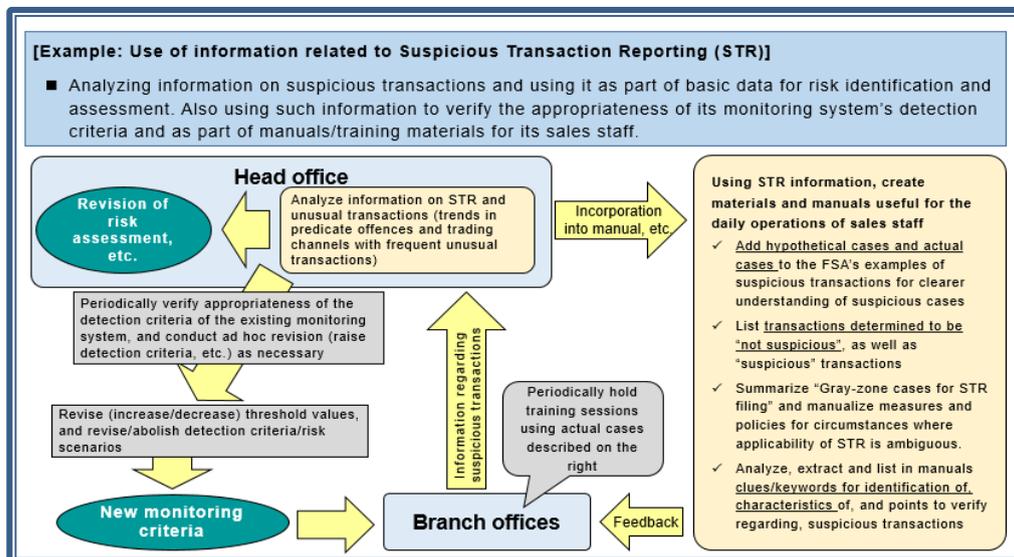
Case Study

Building an effective management system for tackling money laundering & terrorist financing risks

«Message to Financial Instruments Business Operators (FIBOs)»

- To fulfill numerous obligations under the “Act on Prevention of Transfer of Criminal Proceeds” and to take effective anti-money laundering and counter terrorist financing measures, it is increasingly important for FIBOs to establish an appropriate risk management system aligned with the characteristics of their business.

Note: The FSA established “Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism AML/CFT” on February 6, 2018.
- In the past, the SESC’s securities monitoring has found cases where money laundering and terrorist financing risks were inadequately handled as below. Thorough implementation of essential AML/CFT measures is required.
 - (i) Securities trading accounts were opened and used under the name of individuals associated with anti-social forces, due to insufficient confirmation at the time of transaction.
 - (ii) There were trading activities out of two accounts by two different account holders but accessed from a single IP address, but no confirmation was made regarding the possibility of an account having been opened with a false name, fake account, etc.
 - (iii) Insufficient confirmation regarding foreign PEPs
 - (iv) The Risk Evaluation Sheet (a required document for Specified Business Operators) is completed only as a formality, as the risk-based approach has not effectively taken root.
- To ensure that Japan’s financial system maintains global credibility, FIBOs, as one of the key participants, are required to involve management actively and take effective measures to accurately process “notifications of suspicious transactions” based on continuous transaction monitoring and confirm “significant controllers.” Their management framework should be aligned with the products and services offered, the contents of transactions, customer attributes, etc.



2-3 Investigation into market misconduct

1. Purpose of market misconduct investigation

To ensure the fairness and transparency of securities markets for the protection of investors, the SESC, pursuant to the FIEA, investigates suspected market misconduct subject to administrative monetary penalty, such as insider trading, market manipulation, spread of rumors and use of fraudulent means.

2. Overview of recommendations in FY2017

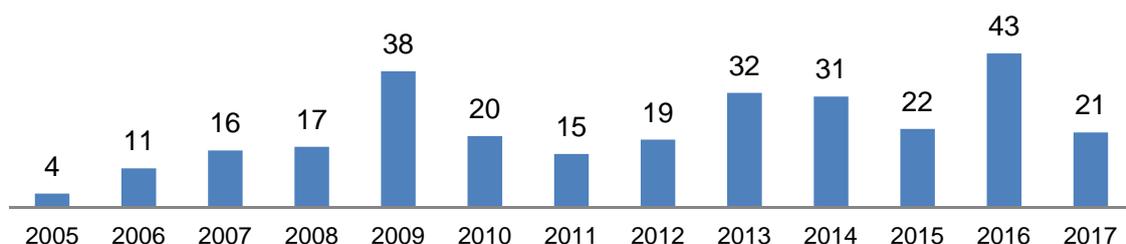
The SESC investigates suspected market misconduct cases in a swift and efficient manner through active use of the Administrative Monetary Penalty System. In FY2017, there were 26 cases of market misconduct (21 cases of insider trading and five cases of market manipulation) in which the SESC made recommendations of administrative monetary penalty payment orders.

(1) Insider trading

In FY2017, there were 21 cases of insider trading for which the SESC made recommendations of administrative monetary penalty payment order, including one cross-border transaction (See Fig. 2-3-1). These included, as in the past, several cases where insider information was leaked by directors of listed companies themselves. Directors of listed companies must manage material facts, etc. appropriately and take the initiative to prevent insider trading. Instead, these directors provided material facts, etc. to others without business reasons, resulting in insider trading. Investors keep a watchful eye on listed companies' internal control systems as well as corporate directors.

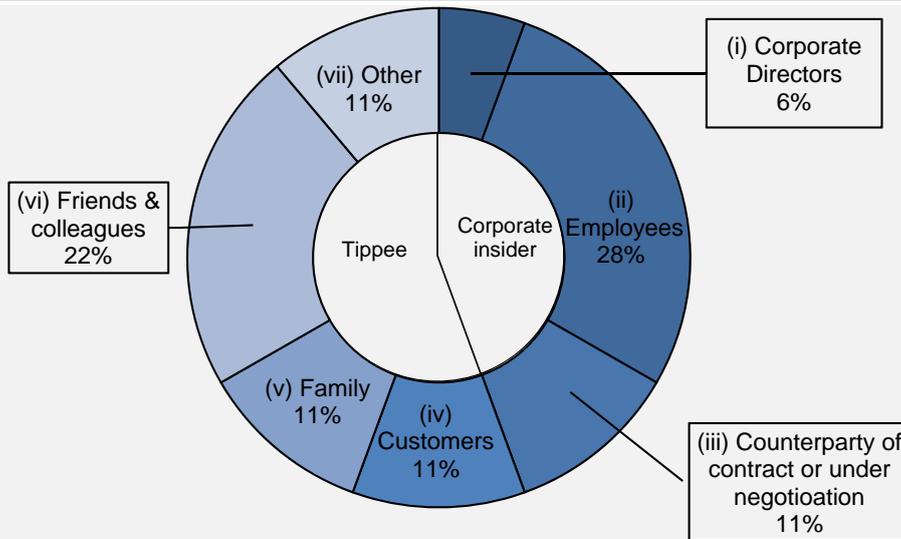
Of total administrative monetary penalty payment orders issued for insider trading in FY2017 (18 cases excluding violations regarding "tipping and trade recommendations"), the largest number of orders were issued against employees of listed companies (27.8 percent), followed by friends and colleagues receiving material facts, etc. from corporate insiders, etc. (22.2 percent). There were several small-lot trades in the amount of several hundreds of thousands of yen, perhaps to conceal misconduct, as well as a case where several tens of millions of yen was borrowed to purchase shares (See fig. 2-3-2).

Fig. 2-3-1: Number of recommendations for administrative monetary penalty payment orders of insider trading



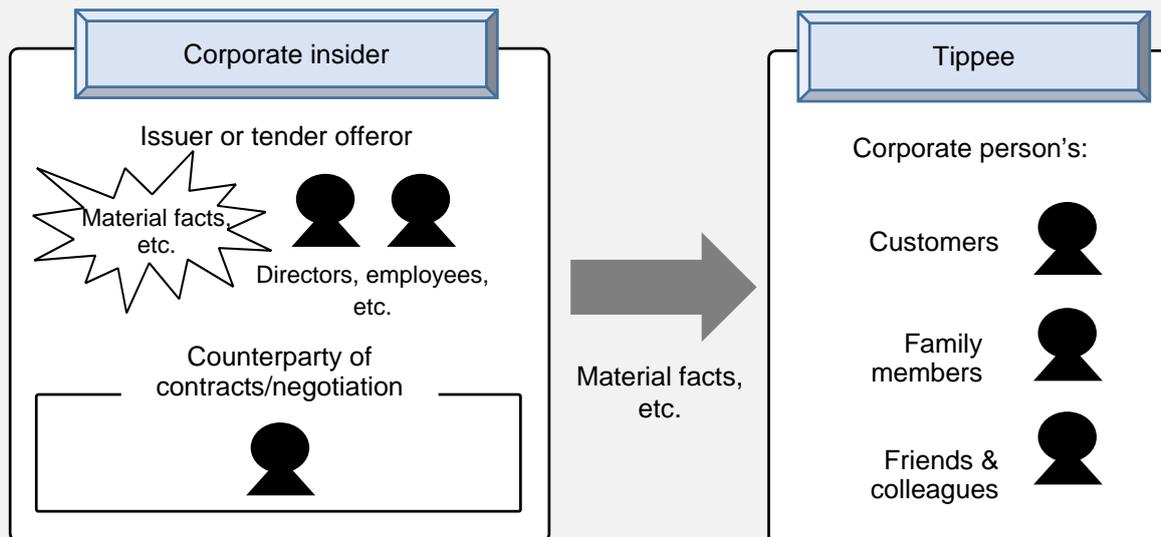
Note: Figures include cases involving cross-border transactions.

Fig. 2-3-2: Attributes of individuals subjected to the SESC recommendations for administrative monetary penalty payment order in FY2017



(Note) Excludes violators of tipping and trade recommendations

(Reference) Attributes of violators



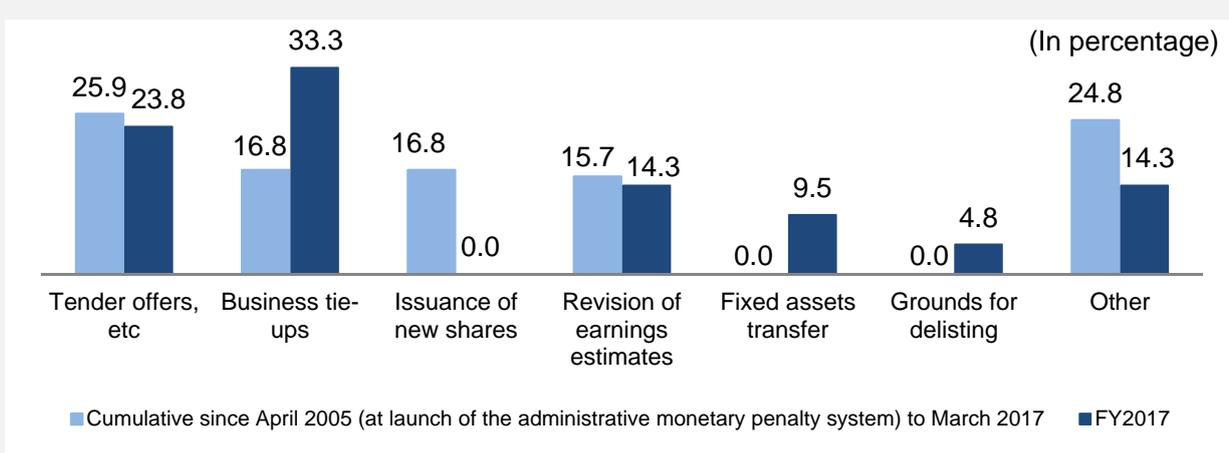
By types of material facts, etc. involved, the SESC’s recommendations in FY2017 (21 in total) included seven cases involving information on business tie-ups (33.3%), five on tender offers (23.8%) and three on earnings revisions (14.3%). Reflecting the need for corporate realignment as a measure to quickly adapt to changes, such as a shift to a borderless and global economy, and growing needs for effective use of precious corporate resources, the number of cases associated with business tie-ups and tender offers continued to be high (See Fig. 2-3-3).

The SESC made recommendations for the first time based on “grounds for the delisting of shares” arising from the status of negative net worth for two consecutive financial terms and “fixed asset transfers” from a decision to sell a tract of land used for

the related company's corporate head office to reduce liabilities, such as interest-bearing debt, etc. The fact that these material facts had triggered insider trading violations evidences that despite the record high-level corporate earnings in Japan, earnings vary among individual companies and that their business environment remains severe. It is likely that similar cases will occur in the future.

Additionally, various counterparties are normally involved in the decision-making process of listed companies for fixed assets transfer/acquisition, including real estate business operators, which act as the intermediary of the intended asset transfer, etc., as well as counterparties of legal documents. Thus, information shall be managed carefully by not only listed companies which are decision makers, but also related parties in the real estate sector, etc.

Fig. 2-3-3: Cases by types of material facts, etc.



The SESC's investigation of insider trading recognized internal control issues in listed companies. For example, a company did not have internal rules for preventing insider trading violations and others had one in place but had not updated the rules appropriately. Further, the SESC found cases where material facts, etc., when they occurred or were decided, were not appropriately communicated to directors and employees in charge of trading management, and resulted in allowing individuals who knew the material facts to conduct insider trading.

Key Case (insider trading):

Description	Date of recommendation/ amount of penalty	Points
Director A of a TSE Mothers listed company (the "Listed Company"), tipped material facts to Director B of a client company of the Listed Company. Separately, Director C of the Listed Company tipped material facts to a family member D. Director B and family member D purchased related shares before the announcement of the information.	January 26, 2018 Director B: 5.54 million yen Director C: 5.03 million yen Family member D: 10.07 million yen	<ul style="list-style-type: none"> ▪ Three violations including two cases of insider trading by Director B & Family member D and one of tipping by Director C ▪ Director A and C of the Listed Company are tipplers. ▪ Director A tipped Director B for business reasons. However, Director B was not advised that the information should be handled as insider information. ▪ Despite there being no business reason, Director C tipped family member D for D's profit.

Key Case (cross-border transaction):

Description	Date of recommendation/ amount of penalty	Points
An individual, who resides outside Japan and is under contract with a JASDAC-listed company (the "Company") sold the Company's shares, knowing the Company's plan to revise its financial performance downward before such information was publicly disclosed.	June 30, 2017 18.57 million yen	This is a case of market misconduct conducted from outside Japan via brokerage firms in four different countries. In collaboration with overseas supervising authorities, the SESC successfully identified the initial entrustor of the transaction.

(2) Market manipulation

In FY2017, the SESC made recommendations for administrative monetary penalty payment orders in five cases of market manipulation, which included one by an institutional investor.

There remained several cases where orders were placed using accounts at multiple brokerages to conceal market misconduct. Backed by the advancement of information

technology, trading schemes have become more complex and cunning, such as layering or spoofing orders¹¹ which use at-market order at closing and combine spoofing orders and wash trades to induce algorithmic orders from other investors. Additionally, there was a market manipulation case where an institutional investor, to gain from its short position and block trade after the close of trading session, manipulated the market toward the end of trading day to cap the closing price.

Key Case (market manipulation):

Description	Date of recommendation/ amount of penalty	Points
Regarding five companies' shares listed on TSE 1st, an individual investor manipulated the market by placing at-market orders at closing for layering or spoofing	November 21, 2017 1.5 million yen	<ul style="list-style-type: none"> • Market order is highly effective in inducing orders from other investors. On top of this, closed conditions remove the risk of unintended execution during a normal trading session. • Use of layering or spoofing orders for both buy and sell • Induced algorithmic trades

Key Case (institutional investors)

Description	Date of recommendation/ amount of penalty	Points
An investment company manipulated the market by placing large sell orders for shares listed on TSE Mothers at prices higher than the best offer price	January 16, 2018 103.41 million yen	The investment company who took short sell positions capped the price by placing a large amount of sell orders at the best offers and above the best offers from seven minutes before the market close, and then bought a large amount of shares by block trade after the market close at a price that was based on the closing market price.

¹¹ An example of a sham order transaction would be placing low priority, large volume buy orders at prices shown on the order book screen without any intention to execute them.

3. Future challenges

(1) Responding to changes

(i) Changes in economic environment

Due to changes in the economic environment in Japan and abroad, share prices are affected by economic activities and companies' value judgements which were not assumed at establishment of the FIEA. For example, certain data falsification, which does not fall under the event that is listed in the FIEA as material facts, may fall under the scope of the so-called "basket clause" under the FIEA, defined as "a material fact which concerns the operations, business or assets of the Listed Company, etc. and has a significant influence on investors' investment decisions." It is important to understand the essence of given cases quickly and apply laws and regulations appropriately to implement market surveillance seamlessly.

(ii) Changes in IT environment

For market misconduct investigations, it is important to ensure the restoration and preservation of the data of the electronic devices, etc. of the entities being investigated. Along with the advancement of information technology, available communication tools have become diverse (e.g., SNS) and a massive volume of data needs to be stored securely. The SESC, led by the Information Analysis Department, has worked towards upgrading the existing digital forensic technology for market misconduct investigations.

(iii) Further collaboration with foreign authorities

The SESC has collaborated with overseas regulators to handle cases of market misconduct perpetrated on a global scale, for example, by using MMoUs.¹² Given the increasing number of cases of suspected market misconduct by foreign investors in the form of cross-border transactions, the SESC aims to address such cases based on effective exchanges of information with overseas regulators through more active communication and rigorous networking.

(2) Enhancing information provision to realize market fairness

As one of the deterrence measures against market misconduct, the SESC releases information regarding its recommendations in a timely manner through the SESC website, press briefing and email newsletter.¹³ Through various lectures and articles, the SESC has also advised listed companies of the importance of building a rigorous framework for combating insider trading violations. During the investigation of insider transactions, the SESC endeavors to understand the effectiveness of the related listed-company's internal control, and, if there is any issue, exchanges opinions with the company as required and shares views on the identified issues. To take the deterrence

¹² Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information

¹³ SESC email newsletter <https://www.fsa.go.jp/haishin/sesc/>

measures against market manipulation, the SESC also shares views with Japan Exchange Regulation, brokerages and others through exchanges of opinions, etc.

In view of enhancing market discipline and maintaining accountability for the development of fair markets, the SESC will continue to release information in a specific and easy-to-understand format, stipulating the significance, details and issues regarding the cases presented.

Case Study

So you think you won't get caught? -Losses you will face from insider trading-

«Message to investors»

Insider traders often believe their violations will not be discovered if:

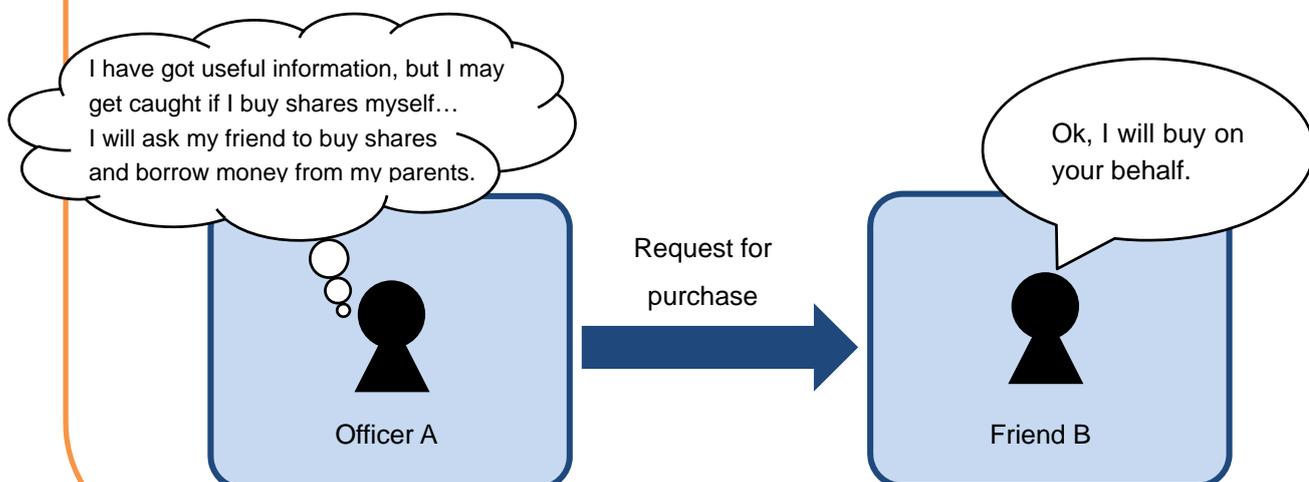
- Trades are initiated via family and friends on their behalf
- The size of trades are small
- They wait for a while before selling shares, rather than selling shares for outright trading gains immediately after the official release of information, which will stand out

As detailed in cases recommended for administrative actions and a case book for penalty payment available on the SESC website, administrative penalty payment has been applied to trades out of accounts in the names of others, such as family and friends (pseudonym trading), and small-lot trades (the smallest trading amount subjected to penalty payment was 190,000 yen in FY2017). Further, penalty payment was applied to cases where the relevant shares were sold six months after the related insider information was published and also where the shares remained unsold.

The Administrative Penalty Payment System is intended to take back the amount equivalent to profits gained through illegal trading. However, the amount of penalty is calculated automatically based on laws and regulations, thus it may exceed actual gains.

In the following example, not only Officer A, but also Friend B who was asked to purchase shares, Officer A's family members who lent money and others who were involved in decision making and information sharing regarding the related material facts, such as Officer A's manager, colleagues and staff members reporting to Officer A, can be subject to the SESC's investigation. In some cases, these individuals lose their jobs. Further, work and family relationship may be destroyed.

You will suffer immeasurable loss from insider trading violations.





The SESC keeps a watchful eye on insider trading activities encompassing multiple countries

«Message to foreign investors»

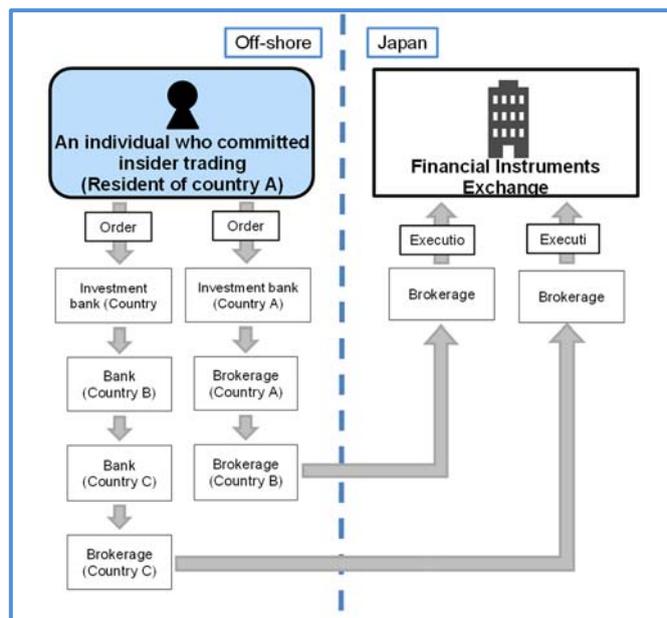
A case of insider trading using cross-border transactions (trades by foreign investors involving two or more countries) is presented below.

Foreign investors' trading share of Japanese equity increased to about 70% of total trading volume in FY2017, twice as much as 25 years ago when the SESC was established (20-30% in FY1992) (data from Japan Exchange Group "Trading by Type of Investors").

Given the increasing number of cross-border transactions, the SESC established the Office of Investigation for International Transactions and Related Issues in August FY2011 to conduct in-depth investigations of suspected market misconduct by individual investors and companies outside Japan.

The Office of investigation for International Transactions and Related Issues has investigated numerous cases of suspected market misconduct, including complex transactions where share purchase orders were placed in exchanges in Japan through multiple countries. The SESC unravels patterns of suspected insider trading through continuous collaboration with overseas market regulators and makes recommendations for administrative monetary penalties appropriately.

The diagram below illustrates one of the cross-border insider trading cases where nine brokerage firms in four different countries including Japan undertook and executed trades. The SESC identified that the trade was ultimately linked to an individual residing in country A.



The SESC keeps a watchful eye on suspected market misconduct involving Japanese equities globally.

2-4 Inspection & information gathering on disclosure requirement violations

1. Purpose of disclosure statements inspection

The FIEA's disclosure requirements are aimed at protecting investors by providing them with sufficient information to make decisions when investing in primary and secondary markets. Specifically, issuers of financial instruments are required to submit disclosure documents, such as Securities Registration Statements and Annual Securities Reports, detailing their business profile, financial condition, etc. The prime minister makes these documents available for public inspection, thereby providing information to investors.

Investors make investment decisions based on the disclosure documents submitted by the issuers of financial instruments. If such documents contain false information or lack information that should be included, investors may sustain unexpected losses.

To avoid this, the SESC conducts inspections of disclosure statements, in which the SESC requires issuers to make corrections to submitted disclosure documents for investors and makes recommendations for administrative monetary penalty against those who violated disclosure requirements by, for example, inserting serious misinformation in the documents. The SESC is also engaged in various activities to prevent the occurrence and recurrence of disclosure regulation violations.

2. Disclosure statements inspection and trends in violations in FY2017

In FY2017, the SESC conducted 31 cases of disclosure statements inspection, including those continued from FY2016. Of these, 14 cases have been complete.

Among the 14 cases, the SESC recommended the issuing administrative monetary penalty payment order in two cases where material misstatements, etc. were found in disclosure documents. Additionally, there were two cases in which the SESC did not find any material misstatement, thus did not recommend penalty payment, but found it necessary to amend the contents of disclosure documents. In this regard, the SESC urged the related issuers to voluntarily submit correction reports, etc. Further, there were cases where the SESC interviewed companies which had been ordered an administrative penalty payment in the past and checked the status of measures to prevent reoccurrence of the violation committed.

Number of completed inspections		14
(Of which)	Number of cases in which imposition of administrative monetary penalty was recommended	2
	Number of cases in which imposition of administrative monetary penalty was not recommended but issuers were urged to voluntarily submit correction reports	2

In view of preventing violations of disclosure requirements and reoccurrence of violations, the SESC, in sync with its disclosure statements inspection, interviews companies to understand the effectiveness of their governance regime and inspects as to “Specified Act of Involvement”¹⁴ as necessary. Note that the SESC found no Specified Act of Involvement in FY2017.

The SESC also started to take measures to prevent violation of disclosure regulations, such as regular monitoring of large listed companies in a forward-looking and macro-level approach, analyses of disclosure documents focusing on specific themes and in-depth analyses of financial and nonfinancial information contained in disclosure documents. This was driven by a violation of disclosure regulations by one of Japan's top global companies and cases arising from the company's inadequate control over overseas subsidiaries over the past few years.

(1) Cases for which imposition of administrative monetary penalty was recommended

Key Cases:

Description	Date of recommendation/ amount of monetary penalty	Background/causes of in appropriate accounting practice
A company's consolidated subsidiary sold a piece of equipment. Against accounting rules, the company posted sales before the equipment was delivered to the buyer and inflated consolidated sales.	December 19, 2017/ 6 million yen	<ul style="list-style-type: none"> ▪ The company's accounting auditor overlooked a potential problem in the sales being recorded ▪ The company's internal control, including subsidiary management, did not function effectively.
A company's consolidated subsidiary falsely stated that it achieved sales target on certain products, thus the company did not record losses from inventory valuation.	February 23, 2017/ 6 million yen	<ul style="list-style-type: none"> ▪ The company's control functions were neglected by the management, due to an excessive emphasis on sales ▪ Accounting process was not documented.

Both the above cases relate to overstatement of sales.

These violations were driven by the lack of a rigorous governance regime, such as ineffective internal control to manage subsidiaries and management's neglect of control functions due to an excessive focus on sales.

¹⁴ “Specified Acts of Involvement” means acts that facilitate or incite the submission of disclosure documents that contain material misinformation.

2-4 Inspection & information gathering on disclosure requirement violations

The SESC believes that recurrence of these disclosure violations can be prevented through in-depth discussions with company management to make them aware of the background/causes of violations and encourage them to build a framework for appropriate information disclosure.

(2) Cases which voluntary corrections were made in the process of disclosure statement inspection

Key Case:

Description	Background/causes of inappropriate accounting practice
For an ongoing construction, despite fact that the timing of completion was uncertain, thus the project was not qualified for the application of percentage-of-completion method, the company went ahead and used this method, thereby backdating sales.	<ul style="list-style-type: none"> ▪ Lack of accounting expertise of the company's accounting department ▪ Inadequate internal control by the internal audit department and auditors

As noted above, even in a case where the SESC do not see any material misstatements that may influence investors' investment decisions, if it is considered necessary to correct the contents of disclosure documents, the SESC urges companies to correct and resubmit their disclosure documents.

The key case above is considered to have resulted from inadequate internal control. Thus, the SESC had a thorough discussion with the company on the background/causes and requested the company to ensure appropriate information disclosure.

(3) Cases for which interviews were conducted to check the status of internal control

Key Cases:

Description	Background/causes of inappropriate accounting practice
The interviewed company's overseas subsidiary capitalized obsolete inventory items that should have been expensed. The company also included fictitious inventory in assets.	<ul style="list-style-type: none"> ▪ The company' president's policy understated the importance of enhancing the company's internal control system ▪ Dysfunctional board of directors /auditors
The interviewed company's consolidated subsidiary transferred the associated costs of a completed construction project to a different project, thereby deferring the accrual of costs. The subsidiary also applied the percent-of-completion method and backdated sales.	Ineffective monitoring by board of directors and auditors over subsidiaries

If it is considered necessary to examine the status of subsidiary management and recurrence prevention measures, the SESC interviews the related companies and discusses the background and causes of the inappropriate accounting practices, even if such companies have already made timely disclosure of inappropriate accounting practices.

(4) Cases where interviews were held regarding recurrence prevention measures

To monitor the progress of recurrence prevention measures, the SESC interviewed companies that had been recommended for administrative penalty payment against fictitious sales in the past. The interviews found no major deviation from the SESC's instructions, such as the development of a compliance system and reforms of internal frameworks and systems.

(5) Disclosure statements Inspection of persons WHO allegedly committed specified Acts of involvement

The SESC also conducts inspections regarding the Specified Acts of Involvement proactively.

In FY2017, as part of disclosure statements inspection in a case of fictitious sales by round-tripping that ended with a recommendation for administrative monetary penalty payment, the SESC inspected a company which may have been involved in the round-tripping, thereby committing the Specified Act of Involvement. The inspection found no Specified Act of Involvement. The SESC will continue to watch for similar cases closely.

3. Future challenges

(1) Upgrading analysis capabilities

The SESC will continue to gather information and conduct analyses focusing on potential risk of disclosure violations that may be triggered by changes in the business environment, etc. For example, the SESC will conduct in-depth analyses by taking an integrated approach, combining micro information, such as business analysis of individual companies and sector-specific business practices, with macro and theme-based analyses.

(2) Actions to prevent violations of disclosure regulations and recurrence of violations

(i) Sharing awareness with management

To prevent the recurrence of violations, the SESC will hold discussions on the causes of violations with the management of listed companies which violated disclosure

2-4 Inspection & information gathering on disclosure requirement violations regulations and share the awareness of existing issues, thereby urging the management to establish an appropriate information disclosure system.

(ii) Effective dissemination of information

As part of measures to prevent violations of disclosure regulations, when disseminating information on cases to which recommendations were made (at press briefings, etc.), the SESC endeavors to provide as clear explanations as possible. The SESC also promotes listed companies' internal discussions towards appropriate information disclosure and dialogue between listed companies and certified public accountants/audit firms by annually publishing a case book presenting violations identified through the inspections. Through active publicization and dissemination of information, the SESC will continue to its efforts to prevent the occurrence and recurrence of violations.

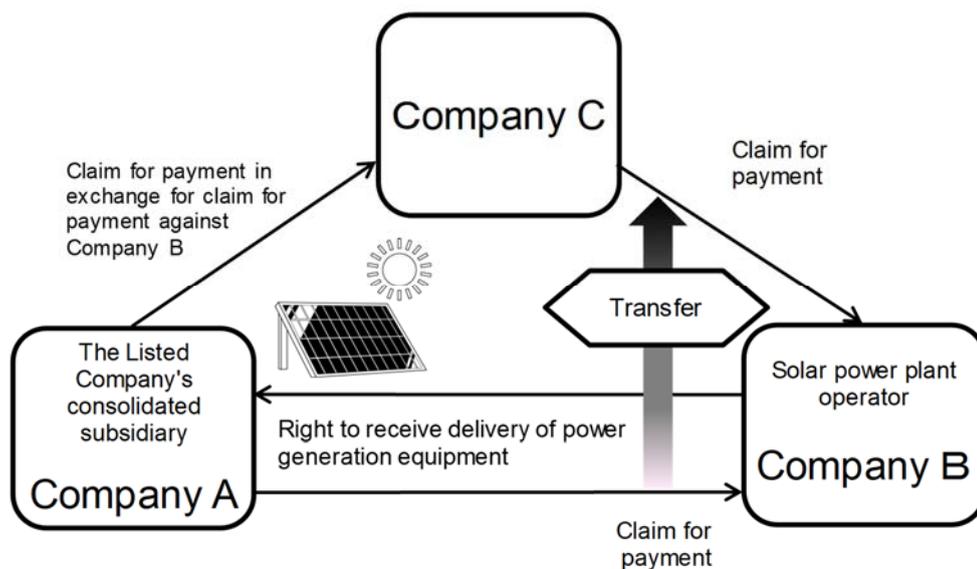
Case
Study

Are you confident of your internal control over your subsidiaries?

«Message to listed companies»

Below is a case of a listed company's violation of disclosure regulations caused by ineffective internal control over its subsidiary.

Company A, a consolidated subsidiary of a listed company (the "Listed Company"), executed a transaction in which Company A transferred to Company C accounts receivable arising from the sale of electricity generation equipment to Company B and in exchange, received payment from Company C. Based on this, Company A recorded sales. Although the equipment had not been delivered to Company B, and, therefore, the transaction did not qualify as consolidated sales. The Listed Company booked the transaction as consolidated sales and thereby inflated the amount of consolidated sales.



To improve its financial position, the Listed Company had converted Company A which had been performing well into a subsidiary. At the same time, the Listed Company tried to improve the then ineffective internal control in Company A, such as the limited number of work-level staff members in charge of internal control. However, Company A became subsidiary through the exchange of Company A's shares held by Company A's representative and the Listed Company's shares. As a result, the representative of Company A became a major shareholder of the Listed Company, which made it difficult to put such initiative forward as intended. Thus, internal control over Company A remained ineffective. Under these circumstances, Company A's performance deteriorated sharply, which triggered the manipulation to inflate sales.

The situation above was caused by the parent company's failure to implement effective internal control over the consolidated subsidiary. The SESC recommends listed companies revisit and confirm the effectiveness of their internal control over subsidiaries.

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. Overview of criminal charges in FY2017

Given increasingly global, complex and sophisticated financial trading activities, the SESC flexibly investigates criminal cases in both primary and secondary markets. In FY2017, the SESC filed criminal charges in four cases, including two cases of suspected insider trading and two cases of suspected market manipulation. These cases included a case of market manipulation where numerous suspects in conspiracy committed violations to raise the prices of certain shares over a long time (filed on November 21 and 27, 2017) and a case where a staff member who worked in an issuing company's finance department, who had the obligation to handle the company's material facts strictly, conspired with his acquaintance and committed insider trading (filed on January 25, 2018).

Cases	Date of filing criminal charges	Filed with
Insider trading of the shares of HIMIKO Co., Ltd.	June 27, 2017	Public Prosecutor of the Osaka District Public Prosecutors Office
Market manipulation of the shares of Stream Co., Ltd.	November 21, 2017	Public Prosecutor of the Tokyo District Public Prosecutors Office
Market manipulation of the shares of Stream Co., Ltd. (2)	November 27, 2017	
Insider trading of the shares of TOSHIBA TEC CORPORATION	January 25, 2018	Public Prosecutor of the Tokyo District Public Prosecutors Office

Of the above cases, the market manipulation case regarding Stream Co., Ltd. shares and the insider trading case regarding TOSHIBA TEC CORPORATION shares were

considered extremely serious and malicious. Details of these cases are provided in the following section (see Appendix 3-7 for others).

3. Notable charges filed in FY2017

(1) Charges in the case of market manipulation of the shares of Stream Co., Ltd.

The SESC filed charges for FIEA violation (market manipulation) against three suspects on November 21, 2017 and an additional four suspects on November 27, 2017 with the Tokyo District Public Prosecutors Office.

(i) Case overview

Suspect A and others conspired and manipulated the market to raise the price of Stream Co., Ltd. ("Stream") shares issued and listed on the Mothers market of the Tokyo Stock Exchange as described below.

1. To induce sales and purchases of Stream's shares, Suspects A, B, C, D and E conspired with other(s) and committed market manipulation from February 13 to 20, 2014 through various trades out of accounts under many different names, including price ratchetings, placing orders to sustain the share price and wash trades. As a result, the share price increased from 410 yen to 576 yen.
2. To induce sales and purchases of Stream's shares, Suspects A, B, C, D and E conspired with other(s) and committed market manipulation from May 22 to 28, 2014 through various trades out of accounts under many different names, including price ratchetings, placing orders to sustain the share price and wash trades. As a result, the share price increased from 574 yen to 800 yen.
3. To induce sales and purchases of Stream's shares, Suspects A, B, C, D, E, F and G conspired with other(s) and committed market manipulation from June 25 to 27, 2014 through various trades out of accounts under many different names, including price ratchetings, placing orders to sustain the share price and wash trades. As a result, the share price increased from 808 yen to 1,059 yen.
4. To induce sales and purchases of Stream's shares, Suspects A, B, C, D, E, F and G conspired with other(s) and committed market manipulation from July 17 to 24, 2014 through various trades out of accounts under many different names, including price ratchetings, placing orders to sustain the shares price and wash trades. As a result, the share price increased from 1,400 yen to 1,510 yen.

(ii) Significance of the case

The above is a market manipulation case where many suspects conspired and committed the act of market manipulation over a long period and iniquitously raised the price of shares.

These suspects not only used accounts under many different names including borrowed-name accounts, but also repeatedly executed large volume of wash trades,

boosting the trading volume in the markets. Further, using methods such as price ratcheting, placing orders to sustain the share price, the suspects' activities in the market seriously influenced share prices that should have been determined by the supply-demand balance. The SESC views this case as extremely malicious and serious, considering the size, the cunning of the method used, etc.

It is necessary to strictly penalize serious and malicious activities to ensure the fairness and transparency of the markets. Filing charges in this case was significant from the perspective of deterring similar cases.

Note that in relation to this case, the SESC obtained support from Japan Exchange Regulation and the Monetary Authority of Singapore.

(2) Charges for insider trading of TOSHIBA TEC CORPORATION's shares

On January 25, 2018, the SESC filed charges for FIEA violation (insider trading) against two suspects with the Tokyo District Public Prosecutors Office.

(i) Case overview

On or around October 16, 2015, Suspect A, who was an employee of the Finance & Accounting Division of TOSHIBA TEC CORPORATION ("TOSHIBA TEC"), listed on the first section of the Tokyo Stock Exchange, came to know in the course of his duty the material fact that TOSHIBA TEC had suffered damage in operation due to an extraordinary loss (see item (ii) below).

Suspect A, with his acquaintance, Suspect B, intended to make profits by selling TOSHIBA TEC shares prior to the announcement of the material fact and buying back the shares after the announcement. The two suspects in conspiracy sold 160,000 TOSHIBA TEC shares for 71,780,000 yen (short selling) on the Tokyo Stock Exchange under the name of Suspect B via a securities firm from October 19, 2015 to November 5, 2015, although there was no exception clause applicable under the FIEA.

(ii) Material fact

The material fact pertaining to this case was that TOSHIBA TEC had suffered damage through the course of operation due to the anticipated extraordinary loss arising from the impairment of assets amounting to 65,957 million yen. (TOSHIBA TEC published the material fact on November 5, 2015 at 3 p.m. through "TDnet", a system operated by the Tokyo Stock Exchange for collecting and releasing listed companies' timely disclosure information).

(iii) Significance of the case

Suspect A, despite his position as a member of the finance and accounting department, with the obligation to handle material facts of issuers strictly, used information of posting the extraordinary loss as an opportunity, and committed insider trading. Thus, he faces extremely serious charges. Suspect B also faces grave

charges, conspiring with Suspect A while knowing such Suspect A's position. Further, the approach taken by two was cunning and malicious. Namely, transacting out of Suspect B's account, instead of Suspect A's, evidences their intention to cover up insider trading.

4. Issues regarding investigation of criminal cases

The SESC will take strict actions against severe and malicious market misconduct by appropriately exercising its authority for criminal investigation and filing criminal charges in cooperation with the 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. To adjust to various changes in the environment, the SESC will endeavor to create a fair and transparent market, by developing human resources with expertise in criminal investigation, while upgrading the systems used in criminal investigations and further strengthening cooperation with related institutions in Japan and abroad, including overseas regulators.

2-6 Enhancing infrastructure for surveillance (IT, human resources)

1. Measures against structural changes in markets

To grasp financial technology trends in and out of Japan and structural changes in securities markets, such as the advancement of IT and artificial intelligence (AI), the SESC interviews financial institutions, IT vendors and audit firms and outsources research projects to outside experts. Based on these activities, in April 2018, the SESC investigated the implications of IT advancement and expansion of Fintech on the markets, assessed issues and risks, considered policies for developing a new market surveillance system, and revised the Medium-Term IT Enhancement Plan which was established in FY2017.

The revised Medium-Term IT Enhancement Plan (the “Revised Plan”) contains policies for the following issues in applying IT in market surveillance activities.

- Developments of Fintech will change existing business processes/models of financial trading and investment activities. Thus, operating in the same paradigm may cause a flaw in market surveillance. It is necessary to continue to work towards seamless market surveillance.
- With the advancement of IT, the quality and volume of information subject to the SESC’s market surveillance changes and increases. Thus, it may not be possible to analyze the information using conventional approaches. It is necessary to upgrade systems in a timely manner.

2. Challenges for the future use of Information Technology

(1) Introduction of new market surveillance system

To adjust to structural changes in markets and continue to monitor markets effectively, the SESC will work to launch a new market surveillance system, which incorporates advanced technologies, in accordance with the policies in the Revised Plan. Specifically, the SESC will analyze issues and conduct pre-verification as to the introduction of AI in relation to the following technologies.

- Technology to extract intelligence data¹⁵ that may be useful for market surveillance from a large volume of publicly available information
- Technology to accurately extract and analyze orders and trades suspected of involving market misconduct from a large volume of order and trade data
- Technology to detect early signs of inappropriate corporate accounting practices from various data on macroeconomic trends, corporate financial performance, etc.

¹⁵ Information that is useful and can be applied universally to various cases as well as specific cases.

- Technology (such as blockchain open API, etc.) to receive data required for market surveillance smoothly and at low cost from market participants, such as financial institutions and self-regulatory organizations

(2) Working with private sector entities to introduce IT (Building a RegTech Ecosystem)

To ensure that financial markets are fair and transparent, it is essential that regulatory authorities, self-regulatory organizations and market participants, such as financial institutions, have dialogue regularly and make efficient and effective IT investment for industry-wide optimization.

Specifically, the SESC aims to enhance financial markets' fairness and transparency by facilitating mutual collaboration and discussion on IT between financial institutions and regulatory authorities through such activities as exchanges of opinions on improving the efficiency of IT investment and IT optimization for the entire financial industry and discussions on technologies that facilitate smooth exchanges of data at a low cost.

(3) Improving digital forensics technology and enhancing the system environment

The IT environment that faces the SESC's market monitoring has been growing more complex, diversified, sophisticated and growing to process huge amounts of data. As electronic devices (smartphones, tablet devices, etc.) have grown more diversified, security and other functions have grown more sophisticated, and the growing use of new IT services (cloud services, etc.) has made the data that the SESC collects more diversified in the past few years.

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

In FY2017, the SESC procured additional equipment for digital forensics technology to respond to increasingly diversified, sophisticated and large-capacity electronic devices for investigations. Specifically, the SESC procured additional pieces of equipment for perpetuation of evidence in smartphones and tablet devices, and by the Medium-term IT Environment Enhancement Plan for digital forensics (established in FY2015), the SESC introduced Analysis Servers for analyzing promptly and efficiently the ever-growing volume of data. The SESC will continue to enhance its IT environment as necessary, in accordance with the medium-term plan.

3. Staff training

(1) Human resources development through OJT and other programs

To develop human resources with expertise and a broad perspective on market surveillance, the SESC provides on-the-job training (OJT) and other training programs for employees to learn the necessary knowhow for conducting inspection and investigation.

In FY2017, the SESC set up the Information Communication Technology (ICT) Training Program which included an OJT program to enhance the expertise of employees. The SESC also implemented training programs to improve managerial employees' project management capability and the communication skills necessary to support the development of their subordinates. Further, the SESC also took measures to improve junior employees' levels of expertise, including a career path seminar where employees with solid work-level experience of inspection and investigation were invited to give lectures, development of criteria to accurately assess the suitability of employees for tasks related to inspection and investigation, and assessment based on such criteria. Further, the SESC exchanged human resources with overseas authorities and sent staff members to seminars sponsored by overseas authorities to learn monitoring, inspection and investigation methodology and enhance the capability to handle international cases (improvement of skills to analyze and research market misconduct using cross-border transactions, etc.) (See Section 2-8-3-(2)).

(2) Promote human resources with expertise

Based on the policy to adapt to changes in the environment through the active promotion of human resources with expertise, the SESC has hired professionals from the private sector, including individuals with expertise and experience in the securities business, attorneys, certified public accountants, etc., and reinforced inspection and investigation related functions since 2000. As of the end of March 2018, a total of 108 individuals were hired through this initiative (18 were hired in FY2017).

Case Study

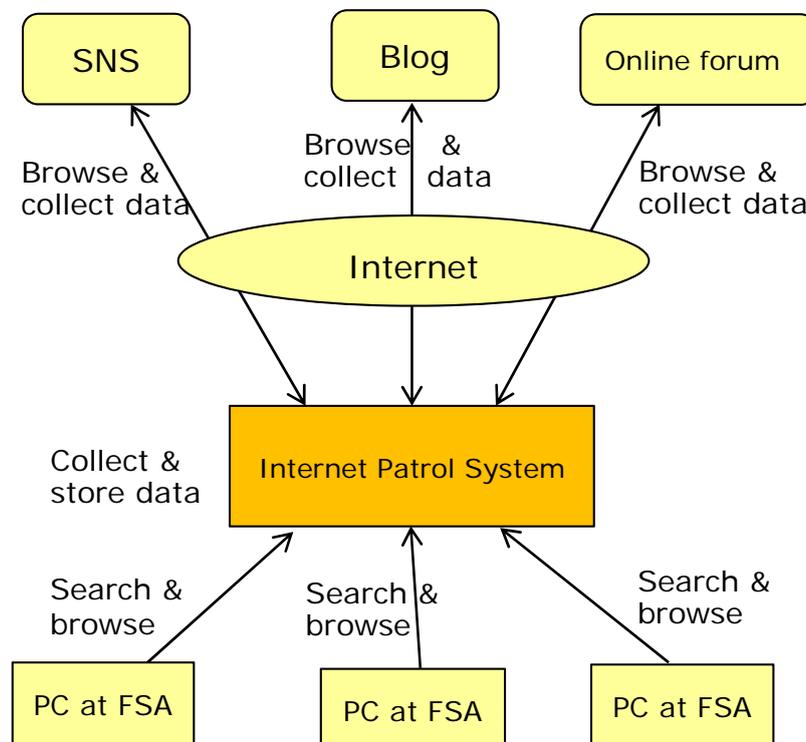
The SESC is monitoring websites such as SNS

«Internet Patrol System»

With the realization of an IT-driven society, various kinds of information on financial instruments trading are posted on the Internet.

Such information includes so-called “spreading of rumors”, which is intended to influence stock prices inappropriately, and information posted by some investors trying to boost the prices of certain stocks. The SESC monitors information on the Internet daily.

Information on the Internet can be updated and deleted. To avoid missing material information on market misconduct, the SESC utilizes the “Internet Patrol System”, which can retrieve and store data from specific websites (social networking services, blogs and online forums), for daily monitoring purposes.



2-7 Efforts to enhance market discipline

1. Enhancing dissemination of information

(1) Dissemination of information through media organizations, media, websites, etc.

The SESC publishes information on important policy decisions and cases in which criminal charges are filed or administrative action is recommended as a result of investigation and inspection. In doing so, the SESC accepts requests from media organizations, such as newspapers, magazines and TV stations, to cooperate for news stories and to submit articles. To promote dissemination of information in the form of articles or opinions based on the implications, analysis, etc. of such cases, rather than just releasing factual information, the SESC will continue to exchange opinions and dialogue with media insiders.

To increase the understanding of the work of the SESC of market participants, the SESC posts up-to-date information on its activities on its website, including summaries of cases in which criminal charges are filed or administrative action recommended and details of given lectures and published commentaries, adding diagrams for complicated cases. The SESC also notifies the latest information posted on its website via the "SESC E-mail Information Service" to registered users and publishes "Monthly SESC E-mail Newsletter", summarizing the SESC's activities, concerns, etc. in a simple, easy-to-understand format. Further, in FY2017, the SESC opened a twitter account and started disseminating various kinds of information. To ensure that the details, issues, etc. of cases in which administrative action is recommended or criminal charges are filed are accurately communicated to the public, the SESC continues to enhance the contents of the information released, including the implications, characteristics and causes of such cases.

The SESC will continue its active efforts to enhance the function of information dissemination to better communicate with a wider audience.

(2) Meetings at local finance bureaus

To enhance market discipline for the fairness and transparency of financial markets and investor protection, it is important to raise the awareness of market participants on the SESC's market monitoring. Additionally, in view of the fact that cases of market misconduct can take place anywhere in Japan due to use of the Internet, it is necessary that the SESC enhance its presence across Japan.

Thus, the SESC started holding its Securities and Exchange Surveillance Meeting at local finance bureaus in FY2015. In FY2017, the SESC endeavored to communicate its views, enhance the SESC's presence and strengthen cooperation with local financial bureaus. (June 9, 2017 at Shikoku Local Finance Bureau.)

In conjunction with the meeting, the SESC exchanged opinions with regional market insiders and explained the SESC's medium-term action plan to deepen their understanding of the SESC's activities and concerns, while working to increase the

SESC's visibility in each region by giving explanations on the purpose of the meeting and an overview of the SESC's operations via a press briefing.

Through these efforts, the SESC aims to work to implement rigorous and appropriate market monitoring for the fairness and transparency of markets and investor protection, while strengthening cooperation with local finance bureaus and regional market insiders.

2. Cooperation with relevant organizations, etc.

(1) Collaboration with self-regulatory organizations

Self-regulatory organizations (SROs, including self-regulatory corporations and financial instruments exchanges and financial instruments firms associations) are engaged in day-to-day monitoring of markets. Their tasks include trade surveillance, listing management, and suitability checks regarding businesses operated by member firms. The SESC works closely with SROs from the perspective of efficient and effective market monitoring.

For further collaboration towards stronger market discipline and market monitoring capability, the SESC regularly meets with Japan Exchange Regulation and the Japan Securities Dealers Association to exchange views on various challenges and issues facing securities markets and to share mutual concerns. In FY2017, the SESC continued to strengthen the collaboration, sharing information and concerns in a timely manner through active discussions on challenges and issues regarding market monitoring.

The SESC believes these efforts will promote dialogue and sharing of views between the SESC and SROs and contribute to the promotion of voluntary actions by SROs, thereby enhancing the self-disciplinary function of markets. The SESC will continue its active exchange of information and communicate its concerns to achieve closer collaboration.

(2) Collaboration with relevant authorities (prosecutors, police, consumer affairs agency, etc.)

In cases where the SESC, in the course of market misconduct inspection, etc., identifies malicious business operators, such as unregistered financial instruments business operators selling fraudulent financial instruments, and activities that may be associated with anti-social forces, the SESC cooperates with police authorities by sharing information, etc. and takes necessary measures. In criminal investigations, the SESC works in cooperation with prosecutors that are the filing authorities for criminal charges on a daily basis. The SESC also exchanges views with tax authorities for stronger cooperation.

The SESC has expanded and deepened cooperation with these authorities through daily exchange of information and meetings, sharing know-how related to investigations, concerns and information from a wider perspective. In FY2016, the SESC launched a meeting to exchange views with the Consumer Affairs Agency. In FY2017, the two organizations reported the status of activities with each other and had discussions on the desirable form of cooperation.

In addition, the SESC held both top- and working-level meetings with regional public prosecutors' offices, prefectural police and regional taxation bureaus on various occasions.

To reinforce disciplinary functions in financial markets through voluntary efforts by market insiders, the SESC also had dialogue and shared views with market insiders proactively, through lectures and meetings to exchange views at bar associations and the Japanese Institute of Certified Public Accountants.

3. Active contribution to the enhancement of market environment

To establish financial markets that are fair and highly transparent and maintain investors' trust in the markets, market rules should be aligned with changes in the environment surrounding the markets. To ensure fairness in transactions, investor protection and the public interest, under Article 21 of the Act on Establishment of the Financial Services Agency, the SESC is permitted to propose measures to facilitate appropriate development of rules that reflect the status of markets to the prime minister, the FSA Commissioner or the Minister of Finance, if considered necessary as a result of investigation, etc.

The above provision is intended to incorporate the SESC's opinions on regulations and self-imposed regulations, etc., formed through comprehensive analyses of the outcome of inspections and investigations, into various measures by the government and SROs. Thus, the SESC's proposals are treated as key information when regulatory authorities, etc. take policy measures.

Specifically, when relevant laws, regulations or self-imposed regulations can be improved to remain relevant with the given status of trading activities, etc., the SESC addresses such needs and presents issues from the perspective of ensuring fair trading, investor protection or the public interest, such as desired regulations and self-imposed rules, and requests revisions to related rules and regulations. The SESC has made a total of 24 such proposals since its launch in 1992 (See appendix 3-8).

The SESC will continue to make active use of the provision to ensure that measures deemed necessary as a result of inspections and investigations pursuant to the FIEA are incorporated in initiatives of the government and SROs.

2-8 Contributing to global market surveillance

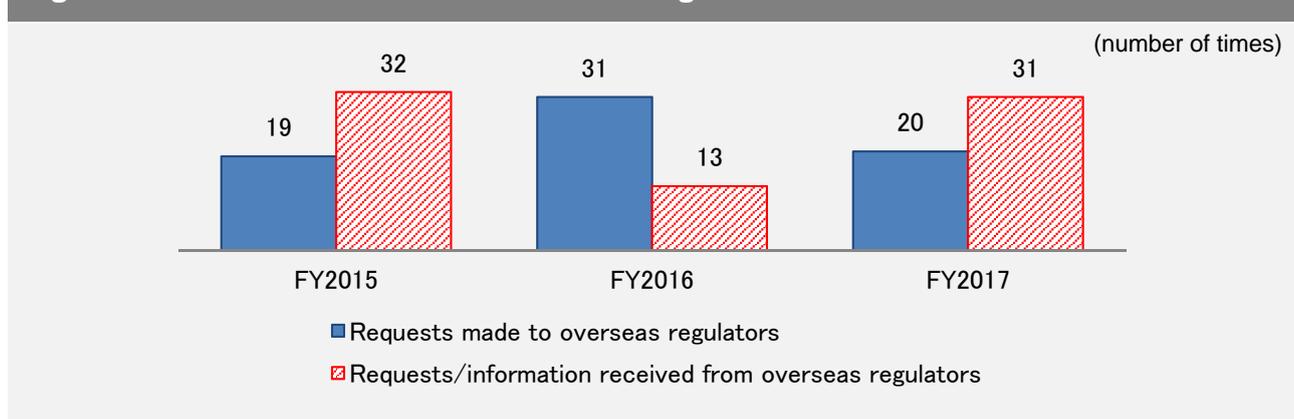
1. Overview of global market monitoring

The environment surrounding global markets is increasingly uncertain as the future of the global economy is unpredictable due to, for example, heightened geopolitical risks including the situation in North Korea. Furthermore, financial markets in Japan are now under the great influence of macroeconomic trends and specific events, as Japanese businesses have been aggressively expanding overseas, foreign investments by Japanese institutional investors have been increasing, and cross-border transactions and the globalization of markets have been progressing, which can be seen from an increase in overseas investor participation in the market.

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 established in January 2017.

The SESC has exchanged various information with overseas regulators based on the International Organization of Securities Commission (IOSCO)'s Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information (MMoU), and enforced laws and regulations against violations involving cross-border transactions.

Fig. 2-8-1 MMoU-based information exchange



The SESC aims to maintain smooth cooperation with overseas regulators by working to develop mutual trust and reinforce exchanges of information and collaboration in executing investigation, inspection and law enforcement. The SESC is also targeting to take advantage of relevant information gained through cooperation on foreign law enforcement cases and legal systems in its market surveillance of the Japanese market.

Further, in the case where issues related to international cooperation are identified through its surveillance activities, the SESC will raise issues and enhance information sharing in

bilateral and multilateral frameworks such as IOSCO, thereby contributing to market surveillance on a global level.

2. Activities at IOSCO

IOSCO is an international organization that aims at coordinating securities regulations across countries and promoting cooperation between regulators. It is comprised of 217 member organizations of various countries and territories, including 128 ordinary, 26 associate and 63 affiliate members. The SESC joined IOSCO as an associate member in October 1993 (the FSA is an ordinary member).

IOSCO holds its Annual Conference under the leadership of the Presidents Committee, the organization's highest decision-making body. In the conference, participants including top officials of the member organizations discuss and exchange views on the current status and issues of securities regulations. In order to conduct effective 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 FY2017, the Annual Conference was held in Montego Bay (Jamaica) in May and SESC Commissioner Mami Indo and administrative staff members participated. Taking advantage of this valuable opportunity where various regulators gathered from all over the world, they hold bilateral meetings to exchange views with key securities regulators. SESC commissioners and senior administrative staff also regularly participate in the Asia-Pacific Regional Committee, where specific regional issues are discussed, and work to strengthen cooperation with overseas regulators.

IOSCO has the IOSCO Board consisting of regulators from various countries and territories, where key regulatory issues facing international markets are discussed and practical solutions are proposed. Under the IOSCO Board there are policy committees discussing individual policy issues. The SESC's representatives participate in the Committee 4 (C4) and the Committee on Emerging Risk (CER) among them.

In C4, members discuss ideal forms of exchange information and cooperation in the area of law enforcement among regulators in order to tackle securities-related crimes and market misconduct associated with cross-border transactions. In CER, members discuss measures to monitor and mitigate systemic risk, emerging risk identification methods, and so on.

The SESC's representatives also participate in the Screening Group, which reviews applications submitted to the IOSCO General Secretariat by regulators to become signatories to the MMoU. In FY2017, an enhanced MMoU (EMMoU) was established to address new law enforcement-related issues. The SESC also contributed to the screening process of applications for signing the EMMoU.

3. Cooperation with overseas regulators

(1) Exchanging views with overseas regulators

The SESC actively exchanges opinions with overseas securities regulators and financial institutions that have global operations, in order to keep abreast of developments in international financial/capital markets and quickly learn about securities regulators' activities to ensure market integrity, while promoting understanding on the SESC's activities. In FY2017, the SESC's representatives participated in the Asia-Pacific Regulators Dialogue on Market Surveillance in Hong Kong in September, where regulators from Asia's market surveillance authorities including the Hong Kong SFC,¹⁶ Singapore MAS¹⁷ and Australia ASIC¹⁸ discussed various working-level issues. Furthermore, the SESC exchanged opinions on various occasions with overseas securities regulators of the United States, Europe and Asia, as well as with globally active financial institutions and international industry organizations, at both executive and working levels.

(2) Sending staff to overseas regulators and participating in short training programs

The SESC has sent its staff to the US SEC,¹⁹ US CFTC,²⁰ UK FSA²¹ (current FCA²²), Hong Kong SFC, Thailand SEC,²³ Malaysia SC,²⁴ and Singapore MAS to have them learn about the surveillance, investigation and inspection techniques of overseas regulators, while introducing the SESC's methods and expertise for surveillance, investigation and inspection in Japan. The SESC has also dispatched staff to participate in short-term training programs hosted by IOSCO or overseas regulators.

Conversely, the SESC regularly offers training programs on Japan's securities market surveillance and investigation of market misconduct for securities regulators among people from financial regulatory authorities of emerging countries, who are invited to the Global Financial Partnership Center (GLPAC) set up within the FSA. Additionally, the SESC also sent its staff to the Myanmar SECM²⁵ in March 2018, to hold a seminar on market surveillance.

To reinforce the global market surveillance regime, the SESC will continue to strengthen networking with overseas regulators and try to achieve a common awareness of concerns through the secondment of the SESC's staff, exchanges of opinions, and visits by senior-level managers.

¹⁶ Securities and Futures Commission

¹⁷ Monetary Authority of Singapore

¹⁸ Australian Securities and Investments Commission

¹⁹ U.S. Securities and Exchange Commission

²⁰ U.S. Commodity Futures Trading Commission

²¹ Financial Services Authority

²² Financial Conduct Authority

²³ The Securities and Exchange Commission, Thailand

²⁴ Securities Commission, Malaysia

²⁵ Securities and Exchange Commission of Myanmar

Case Study

SESC 25th anniversary international conference

- New stage based on a quarter-century of achievement -

The SESC, which was established in July 1992, marked its 25th anniversary in 2017. To commemorate this, the SESC hosted an international conference titled “Market Surveillance to Support Sustainable Economic Growth: New Stage based on a Quarter-Century of Achievement” at the Mita International Conference Center, Tokyo, in December 5, 2017.



Welcome & keynote speech by Chairman Hasegawa

Experts in and out of Japan were invited to the conference as panelists to discuss three key issues in terms of the SESC’s future role. Additionally, Mr. Takafumi Sato, President of Japan Exchange Regulation, and Mr. Ashley Alder, Chair of the International Organization of Securities Commissions (IOSCO), gave keynote speeches.

Issue 1: From savings to asset formation: Key drivers

- The status and future challenges to achieve an optimal flow of funds in Japan as a whole were discussed, including ESG investment activities and development of a market environment in the US.
- Key drivers for a successful shift from savings to asset formation were identified, which included enhancement of financial education programs including risk education, diversification of investment including time/currency aspects, establishment of appropriate commission and compensation systems, and law enforcement for a fair and transparent market.

Issue 2: Corporate governance of global companies: Challenges & good practices

- While accounting scandals by global companies and governance issues at overseas subsidiaries have been identified in recent years, ongoing activities and challenges for gaining investors’ confidence towards Japanese companies were discussed.
- Opinions were shared, such as that internal audit can be more efficient through group-wide standardization of corporate structure and rules, and that it is important that Japanese auditors enhance governance of local auditors to perform high quality accounting audits for global companies.

- There was an opinion that foreign investors expect Japanese companies' boards of directors to have the capability to take in global business, which include the understanding of markets, regulations in and out of Japan, and local companies.
- The SESC recognized the necessity of in-depth market monitoring such as not only to notify market violations but also to analyze governance status as a root cause.

Issue 3: Market surveillance & innovation: Establishing a RegTech ecosystem

- After explanation of the situation of Japan's blockchain technology and market surveillance activities using artificial intelligence (AI), desired market monitoring practices in development of information technology were discussed.
- Participants discussed the technological possibility of reducing financial institutions' huge burden of costs for regulatory compliance, such as further digitization of statutory documents.
- It was indicated that establishment of a RegTech ecosystem would help not only the reduction of companies' costs, but also improvement of regulators' market surveillance techniques.
- The SESC recognized that it is essential to establish a RegTech ecosystem to effectively respond to technological innovation, and to this end, it is needed to cooperate with the private sector utilizing its capabilities and knowledge to develop financial markets.

Over 350 delegates associated with securities markets and regulators from 16 countries participated in the conference. The SESC received a lot of positive feedback from them.

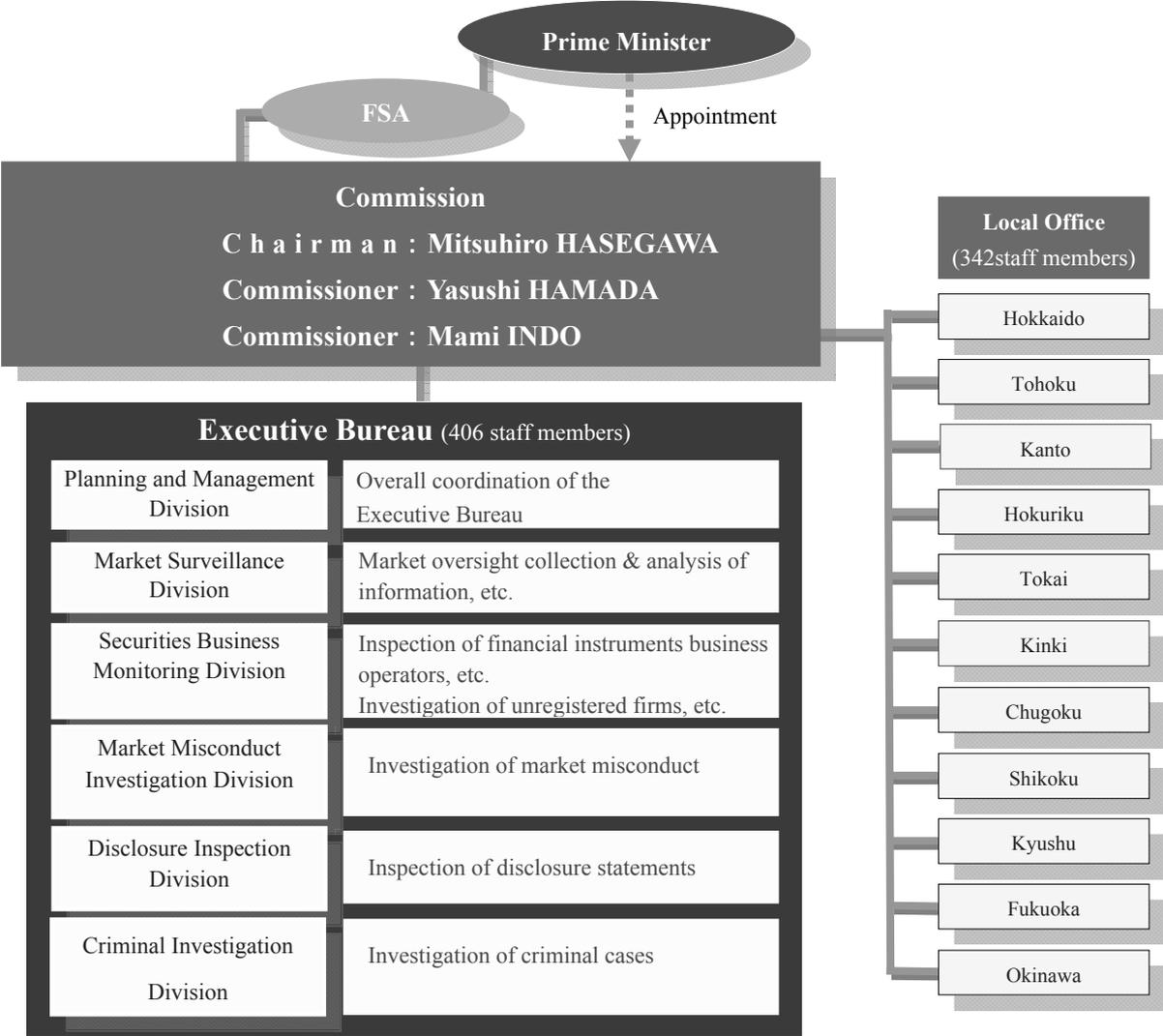
Facing a new stage, the SESC will contribute to the sustainable growth of the national economy through proactive dialogue with market participants based on the outcomes of the conference. The SESC will also improve oversight techniques as a market surveillance professional to eliminate and prevent market abuse that may interfere vigorous investment activities by drilling down to their root causes.

Japan's capital markets cannot prosper through the SESC's efforts alone. Your cooperation and support are essential. We appreciate your continuing support in the future.

Appendices

Table 1

Organization

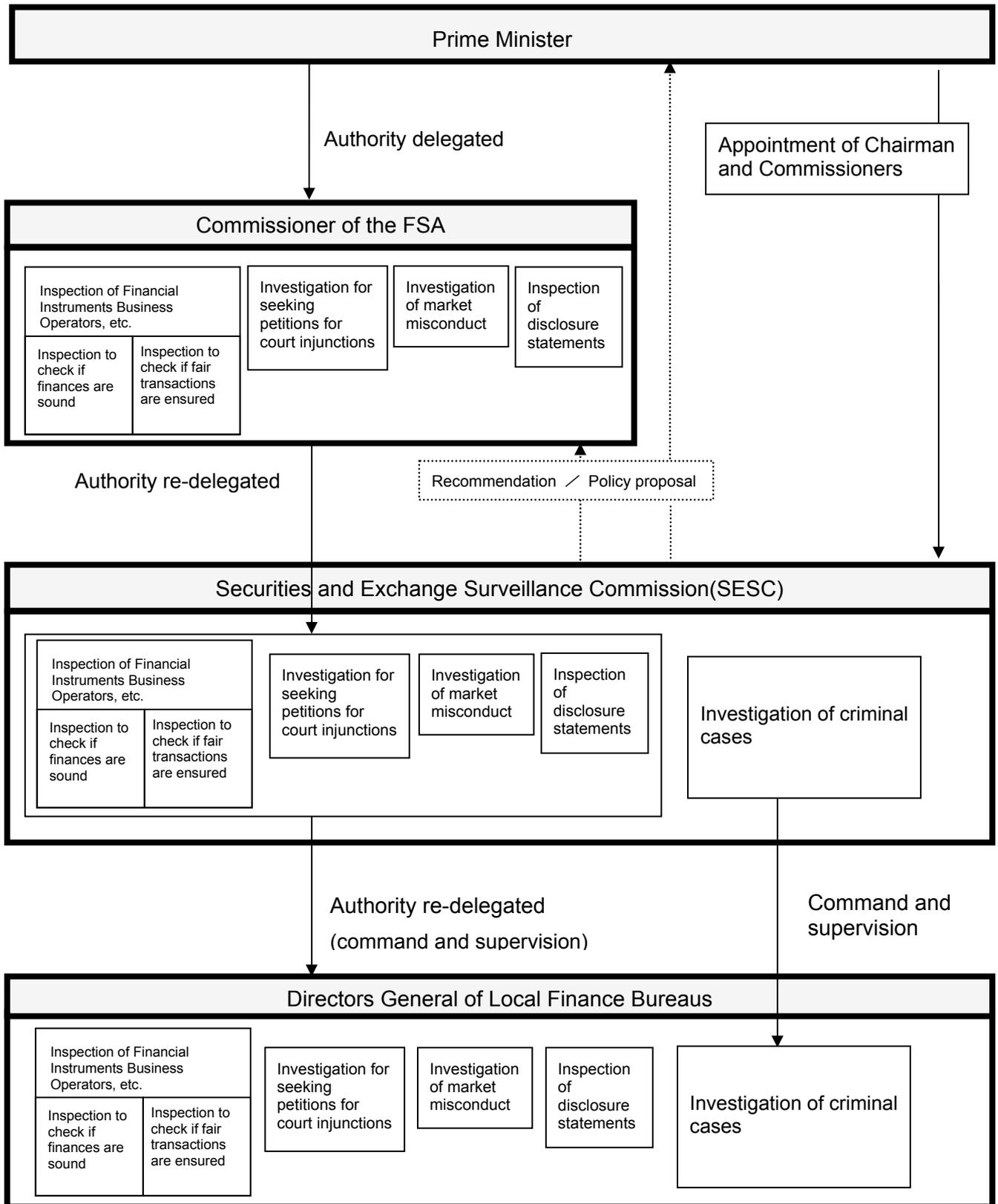


Note1: Staff members of Executive Bureau are quota as at the end of FY2018.

Note2: In July 2006, the SESC was transformed from two divisions (the Coordination and Inspection Division and the Criminal 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 Planning and Management Division, the Market Surveillance Division, the Securities Business Monitoring Division, the Civil Penalties Investigation and Disclosure Documents Inspection Division, and the Criminal Investigation Division). Furthermore, in July 2011, the Civil Penalties Investigation and Disclosure Documents Inspection Division was divided into two divisions (the Market Misconduct Investigation Division, and the Disclosure Inspection Division), meaning that the SESC was transformed into six divisions. In August 2011, Cross-Border Investigation Office was established within the Market Misconduct Investigation 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))

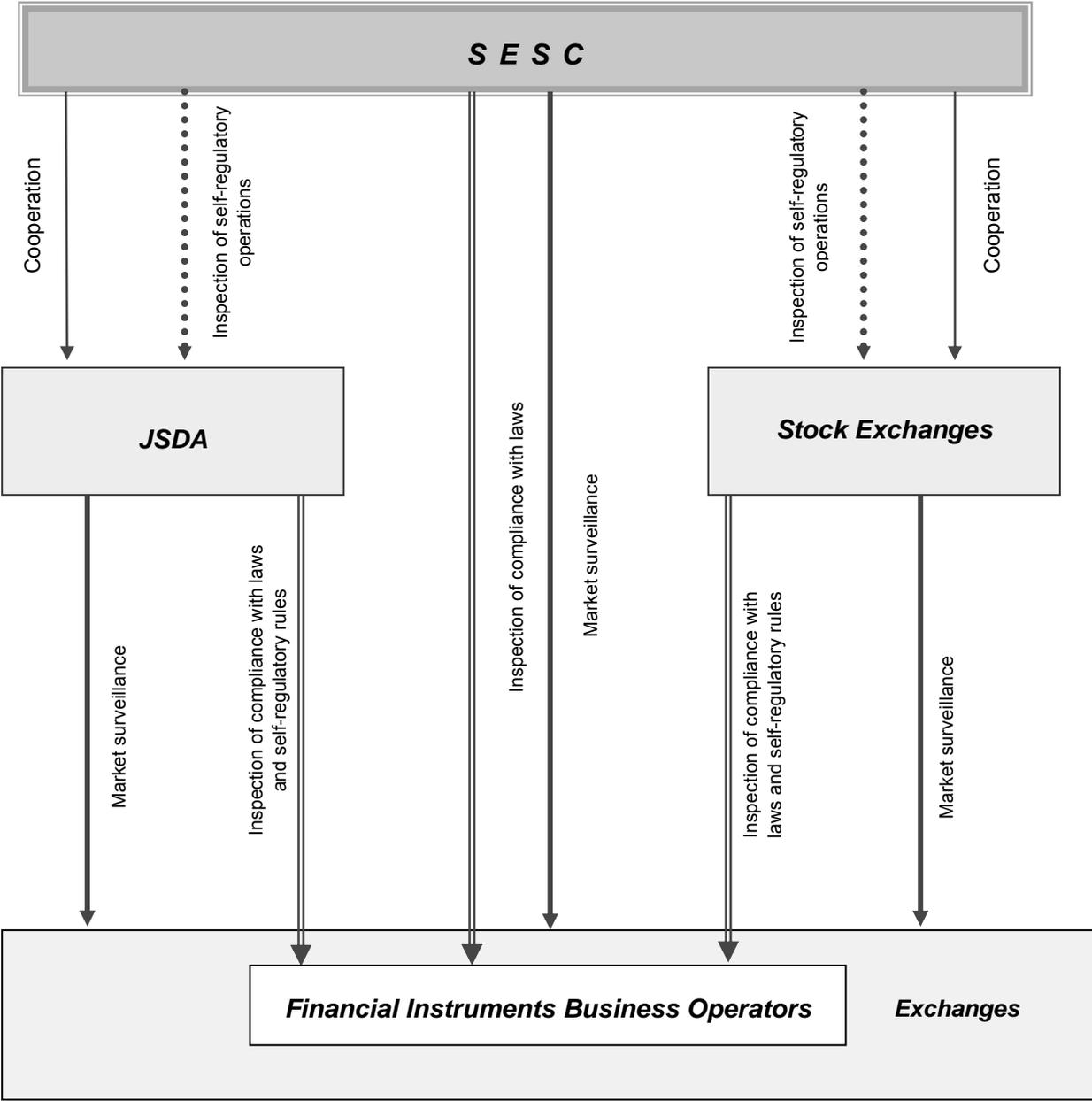
(Note 2) For an investigation of a criminal offence, the SESC directs and supervises the Director General of a Local Finance Bureau or the Director of its branch office. The SESC may, deeming it necessary for investigating a criminal offence, direct and supervise firsthand an official of a Local Finance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

Table 3

Relationship with Self-Regulatory Organizations



Financial and capital market

Note: The same system applies to financial futures.

Table 4

Activities in Figures

Table of Summary

Unit: Number of cases

Fiscal year		1992 to 2012	2013	2014	2015	2016	2017	Total
Category								
	Criminal charges	164	3	6	8	7	4	192
	Recommendations	704	70	66	59	91	38	1,028
	Recommendations based on securities inspections	462	18	16	18	35	10	559
	Recommendations to pay administrative monetary penalty (market misconduct)	168	42	42	35	51	26	364
	Recommendations to pay administrative monetary penalty (false statements in disclosure statements, etc.)	71	9	8	6	5	2	101
	Recommendations for order to submit revised report, etc.	3	1	0	0	0	0	4
	Announcement of results of inspection of persons making notification for business specially permitted for qualified institutional investors	14	11	17	17	23	4	86
	Petition for a court injunction, etc., against unregistered business operator or solicitation without the filing of securities registration statements	6	2	6	3	1	2	20
	Proposals	23	0	1	0	0	0	24
Securities inspections	Financial instrument businesses operators	2,460	222	206	128	37	25	3,078
	Type I financial instrument businesses operators	1,988	69	77	61	16	19	2,230
	Type II financial instrument businesses operators	64	108	72	32	9	2	287
	Investment management firms Investment advisories/agencies	408	45	57	35	12	4	561
	Registered financial institutions	335	9	1	1	0	0	346
	Persons making notification for business specially permitted for qualified institutional investors	30	23	31	30	20	0	134
	Financial instruments intermediaries	23	8	18	19	2	0	70
	Credit rating agencies	7	0	2	0	0	0	9
	Self-regulatory organizations	23	3	3	3	0	0	32
	Investment corporations	42	3	2	1	1	0	49
	Other	4	3	3	3	1	0	14
	Total	2,924	271	266	185	61	25	3,732
	Market oversight	11,592	1,043	1,084	1,097	1,142	1,099	17,057

Notes

- Total number of securities inspections refers to the number of cases that have been started.
- 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.

November 14, 2017

Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2017–June 2018)

Introduction

The missions of the Securities and Exchange Surveillance Commission (SESC) are: (1) Ensuring market integrity/protection of investors, (2) contributing to sound development of markets and (3) contributing to sustainable economic growth. Under these missions, the purpose of the SESC's monitoring of financial instruments business operators (FIBOs, or securities businesses¹) is to ensure investors' confidence in the markets. For this purpose, the SESC encourages FIBOs to enhance self-discipline to perform their function as market intermediaries and operate properly in compliance with relevant laws, regulations and market rules.

In the “*Strategy & Policy of the SESC 2017-2019*,” released in January 2017, the SESC cited “effective risk-based monitoring of regulated entities” as one of the concrete measures to fulfill the missions for the period. For this measure, the SESC has been collaborating with relevant departments of the Financial Services Agency (JFSA).

This document outlines the principle approach to monitoring FIBOs and sets forth the areas of focus in the monitoring activities, in the 2017–2018 business year.

1. Monitoring Priorities for Securities Businesses

(1) General environment surrounding securities businesses

Not much expansion has been seen in the customer base of securities businesses, with the majority of Japan's household financial assets still held in the form of cash or deposits. The customer base is aging, making it an important management issue for securities businesses to develop sustainable business models, for example, changing main selling products.

Under such circumstances, some securities businesses aim to expand their customer base by aggressively promoting businesses in collaboration within

¹ FIBOs or securities businesses are any businesses that are subject to securities monitoring pursuant to the Financial Instruments and Exchange Act, including financial instruments business operators, registered financial institutions, financial instruments intermediaries, persons made notification for business specially permitted for qualified institutional investors, credit rating agencies, and so on.

their groups, which increases the risk of potential conflict of interest. Others have significantly changed their business strategies under the stricter financial regulations around the world and the changing market environment.

Cybersecurity measures and Fintech businesses have become an important management issue.

(2) Approach to monitoring securities businesses

Securities businesses subject to monitoring by the SESC currently total approximately 7,000, and these firms offer an increasingly diverse and complex set of services and products. They include businesses that do not fully establish basic controls to comply with relevant laws and regulations in order to protect investors.

Therefore, it is essential to make best efforts to conduct effective and efficient monitoring of securities businesses and identify risks that could undermine investors' confidence.

Since the last business year, the SESC has introduced a strategy of selecting the businesses subject to on-site monitoring based on the off-site risk assessment on all securities businesses. The assessment contains the analysis of business environment covering economic and industrial trends and the entity's business model. The SESC will continue to implement this strategy in the current business year.

In conducting on-site monitoring, the SESC aims to not only point out legal problems but also analyze the whole picture of the problems to identify root causes, so that businesses can address them and prevent recurrence.

Where identifying the need for improvement of management systems or other potential issues which may not necessarily have become materialized problems, the SESC will share the findings with the subject of the on-site monitoring and encourage them to build an effective internal control system or address issues.

(3) Activities in the last business year

The SESC focused particularly on not only risk assessment of entities' business models, but also both the effectiveness of their governance and the appropriateness of their risk management in light of their business models.

The SESC especially looked into operations of securities or investment management businesses in line with their operational scale and characteristics, with a focus on their governance and risk-control structure as it relates to the three lines of defense, by analyzing the submitted documents and holding dialogues with them. As a result, the SESC identified issues such as the need

for more active engagement of directors in discussions at board meetings and enhancement of the oversight functions of outside directors at securities companies. On the other hand, some investment management business operators were found to need improvement in their control of conflict of interest.

As there are large numbers of Type II FIBOs, investment advisors/agencies, and persons made notification for business specially permitted for qualified institutional investors (QII business operators), the SESC strived to identify problems as early as possible by extracting high risk businesses and carrying out on-site monitoring on them based on the analysis of risks associated with their products and tips provided by outside sources.

(4) Policy for activities in the current business year

The SESC will utilize accumulated knowledge from last business year's activities and focus more on changes in the business model of each company. In its risk assessment of securities businesses, the SESC will make efforts to identify potential issues and also narrow down monitoring area for which its review has been deemed necessary.

The SESC will aim to conduct on-site monitoring to clarify details in cases where any of the following situations are identified:

- ① Violations of relevant laws and regulations or internal control deficiencies that need immediate attention
- ② Solicitation for financial instruments with unclear risk profile
- ③ Possible serious problems concerning protection of investors (e.g., segregated management of customer assets is not ensured).

2. Industry-wide and thematic monitoring priorities

In monitoring securities businesses, the SESC will aim to work closely with relevant departments of the JFSA to look into the following as thematic monitoring priorities applied across the industry, proceeding in accordance with the "*Strategic Directions and Priorities*²".

- ① Customer-oriented business conduct
- ② Cybersecurity
- ③ Trade surveillance of High Frequency Trading
- ④ AML/CFT (Anti-Money Laundering/Counter Financing of Terrorism)

Additionally, the SESC will flexibly examine FIBOs on other themes in response to changes in the environment surrounding them.

² The JFSA released the 2017-2018 Strategic Directions and Priorities on Nov. 10, 2017.

3. Monitoring strategies for various FIBOs business models

In accordance with the “*Strategic Directions and Priorities*”, the SESC will mainly look into the following aspects of FIBOs based on their scale of operations and type of service.

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

- Business trends in Japan and abroad, and changes in their business models
- Appropriateness of risk and compliance management systems in light of their business models
- Viability of governance, including effectiveness of internal audits and IT
- Management of conflict of interest (for securities businesses under the three mega banking groups, as they are seeking to expand their customer base through collaboration between banking and securities operations)

(2) Foreign securities firms

- Changes in business models, profit structure and risk profile at a base in Japan as they relate to changes in their global strategies in response to amendments of international financial regulations.
- Effectiveness of internal control, in view of observed moves to enhance efficiency through outsourcing internal control operations to overseas entities.

(3) Securities companies, other than those described above

- Effectiveness of governance to ensure appropriate operation in light of changes in profit structures and new services introduced, especially at traditional face-to-face securities business model, in view of the aging of their customer base.
- Sufficiency of risk assessment of newly introduced products and appropriateness of solicitation and sales practices in light of the principles of suitability, in view of observed moves to exit from a profit structure relying on brokerage fee revenues and diversify revenue sources.
- Changes in governance structures and business models in case a firm's capital structure changes significantly.

(4) Foreign currency margin transactions (FX transactions) business operators

- Measures to protect investors as a precaution against occurrence of events that can significantly affect the foreign exchange market
- Risk management system of FX transactions business operators

(5) Investment management business operators

- Effectiveness of management of conflict of interest, product development processes and portfolio liquidity management for funds
- Effectiveness of management of investment products

(6) Investment advisors/agencies

- Misleading advertisements
- Solicitation by deceptive means

(7) Type II FIBOs

- Substance of businesses that receive investment from the funds they handle and the management of money invested in funds
- Misleading advertisements

(8) QII business operators

- Substance of invested businesses and management of money invested in funds

In particular, the operations since March 1, 2016, when the amended Financial Instruments and Exchange Act (FIEA) took effect, will be focused on.

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

For other securities businesses, including registered financial institutions, credit rating agencies, financial instruments intermediaries, and self-regulatory organizations (SROs), the SESC will conduct risk-based monitoring in light of the firm's particular business types.

(10) 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. Where appropriate, the SESC will exercise its investigative authority to seek court injunctions to force these firms to cease or suspend activities that violate the FIEA. The SESC will also continue to take strict actions, including public disclosure of their names, the names of their representatives, and the nature of their illegal conduct.

4. Cooperation with Local Finance Bureaus and other relevant organizations

The SESC will collaborate closely with Local Finance Bureaus (LFBs). If the jurisdiction falls over multiple LFBs, the SESC will strive to enhance its guidance and

coordination functions, working out ways to collect information, share analytical results with relevant LFBs and consider appropriate monitoring methods.

The SESC will continue to work closely with SROs, including by sharing information and perspectives on problems with them to raise the efficiency of monitoring programs and to ensure fairness and transparency in the markets.

5. Feedback to entities subject to monitoring

Problems, as well as best practices for other FIBOs, found through monitoring will be fed back to individual FIBOs, in cooperation with relevant departments of the JFSA if necessary, in order to encourage their voluntary efforts.

The SESC will also provide the public with more information about its monitoring results of securities businesses in a specific and straightforward manner as a way to help market participants to correctly understand the SESC's perspectives on issues requiring attention, including the publication of the *“Overview of Monitoring of Securities Businesses and Case Studies.”*

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

Fairness Fair and independent oversight	Accountability Holistic and root-cause analysis coupled with public outreach	Forward-looking Perspective Early detection of signs of market misconduct	Effectiveness and Efficiency Effective use of resources	Strong Collaboration Working closely with SROs and other competent authorities, both domestic and overseas	Commitment to Excellence Committing to achieve highest standards of oversight
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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
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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 FinTech¹ could make further changes and innovations in the markets. At the same time, threats of cyber-attacks against the financial system have been growing.

¹ “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 pools², 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

² 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 intelligence³ 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.

³ "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 (RegTech⁴) 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 Forensics⁵ 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.

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

⁵ “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 25th 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 cycle⁶. In order for that, the SESC will conduct continuous review of its market oversight approach by listening to views among external experts.

⁶ "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**



"for investors, with investors"

* 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.

The Securities and Exchange Surveillance Commission

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