

# Annual Report 2018/2019

Securities and Exchange Surveillance Commission

# Annual Report 2018/2019

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

# Introduction

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The Securities and Exchange Surveillance Commission (SESC) functions as a commission, consisting of a Chairman and two Commissioners and the Secretariat attached to 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 26 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 the malicious market misconducts. Furthermore, over the years, the SESC expanded its authority to make a recommendation for administrative monetary penalty payment order in 2005 and to inspect funds in 2007, while the divisions of Executive Bureau of the SESC has been expanded from two to six divisions. Through this expansion and enhancement, the SESC not only filed criminal charges against cases of malicious violation but also has contributed to the soundness of the markets by effective monitoring and investigations as well as using the administrative monetary penalty system efficiently.

## Key Achievements

As the environment surrounding markets is changing very rapidly, the SESC need to be well informed of the background of the problems that might occur in the capital markets in order to respond them in an appropriate manner.

Under the new organizational structure launched in 2016, the SESC, the watchdog of the capital markets, has not only made recommendations for administrative monetary penalty payment orders and filed criminal charges, but has also worked to pursue its newly added agenda of "root-cause analysis" and "preemptive actions against market abuse," outlined in the "Strategy & Policy of the SESC 2017-2019" announced in January 2017.

In 2018, the SESC conducted market surveillance in a timely manner, gathered and analyzed information with a focus on potential risks from macro-economic

perspectives. We also worked with self-regulatory organizations (SROs) and foreign authorities, and kept a close eye on what was happening in both domestic and overseas markets. We also improved our market monitoring. With respect to the monitoring of Financial Instruments Business Operators, we conducted on-site monitoring based on risk assessments. Furthermore, we effectively used the administrative monetary penalty system to perform prompt and efficient monitoring and investigations, and responded with rigorous enforcement in the case of very serious or malicious cases. In addition, for investor protection, we made policy proposals to Prime Minister and the Commissioner of the FSA based on the results of monitoring and investigations. One of the proposals included more information provisions of borrowers to investors in the funds investing in loan business, which has increased in recent years.

## Future Challenges

While the world economy is moderately recovering, its future is increasingly uncertain. 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, advances in digitalization speed up transaction processing in the markets.

Amid this market environment, the SESC needs to take actions to ensure that market monitoring is seamless. Specifically, in addition to collaborating with relevant authorities, we need to step up cooperation with self-regulatory organizations, industry organizations, and foreign authorities. We also need to develop and improve methodologies of inspection and investigation, and accurately identify and monitor market developments such as the emergence of new products and types of transactions. It will also be necessary for us to respond to illegal conduct rigorously and appropriately, and to work on enhancing the sophistication of the digital environment for monitoring and investigations. It is also important to pursue dialogue with relevant parties in the markets (engagement) as a way to enhance market discipline.

This annual report outlines the SESC's activities in FY2018 and explains its views on 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 shared with as many

market participants and investors as possible, contribute to understanding of the SESC's activities and thereby to establishing fair and transparent markets.

August 2019

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	<b>SESC established in the Finance Ministry</b>	
1993		<b>Filing of criminal charges:</b> 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	<b>Administrative monetary penalty system introduced</b> SESC mandated to exercise investigative authority SESC mandated to exercise inspection authority on disclosure statements Additional inspection authority granted to SESC (inspection of financial soundness, inspection of investment advisors)	<b>Filing of criminal charges:</b> 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	<b>Filing of criminal charges:</b> Spreading of rumors, fraudulent means related to Livedoor Marketing Co., Ltd. shares <b>Filing of criminal charges:</b> Insider trading related to Nippon Broadcasting System, Inc. shares
2007	Additionally mandated to exercise authority on inspections of investment funds	Financial Instruments and Exchange Act in full effect
2008	Additionally mandated to exercise authority to conduct disclosure statements inspection on quarterly securities reports and internal control reports; additionally mandated to exercise authority to conduct investigation for potential imposition of administrative monetary penalties on violations in quarterly securities reports (1) Additionally mandated to exercise authority to conduct Disclosure Statements Inspection on false disclosure statements in Tender Offer Notifications, Reports of Possession of Large Volume (2) Additionally mandated to exercise authority to conduct investigation for potential imposition of administrative monetary penalties related to market manipulation by means of Fictitious or Collusive Sales and Purchases (3) Additionally mandated to exercise authority to file petitions for court injunctions against violations by unregistered business operators	
2010	Additionally mandated to exercise authority to inspect credit rating agencies	
2011	Additionally mandated to exercise authority to inspect group companies (consolidation regulation of large securities companies introduced) <b>Six-division structure</b> 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	<b>Filing of criminal charges, recommendation for administrative monetary penalty:</b> False

		disclosure statements in Securities Report related to Olympus Corporation <b>Recommendation for administrative disciplinary action, filing of criminal charges:</b> AIJ Investment Advisors Co., Ltd. (false notifications, violation of duty of loyalty, etc.)
<b>2013</b>	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	<b>Recommendation for administrative disciplinary action:</b> MRI International, Inc. (false notification, etc.)
<b>2014</b>	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	
<b>2015</b>	Office of IT Forensics and Information set up  Additionally mandated to exercise authority to conduct inspections on specified financial benchmark administrators	<b>Filing of criminal charges:</b> 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 <b>Recommendation for administrative monetary penalty:</b> False statements in Securities Report related to Toshiba Corporation
<b>2016</b>	Office of Market Monitoring set up Litigation Office set up	<b>Recommendation for administrative disciplinary action:</b> Arts Securities Co., Ltd. (false notification, etc.)
<b>2017</b>		<b>Filing of criminal charges:</b> Use of fraudulent means by Arts Securities Co., Ltd., etc. (MARS); market manipulation in relation to shares of Stream, Co., Ltd.
<b>2018</b>	Additionally mandated to exercise authority to conduct inspections on high speed trading business operators	<b>Filing of criminal charges:</b> False statements in Securities Report related to Nissan Motor Co., Ltd. <b>Recommendation for administrative monetary penalty:</b> Manipulation of market for long-term government bond futures by Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.

## 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 the Securitization of Assets (Act No. 105 of 1998)
Act on Transfer of Bonds, etc.	Act on Book-Entry Transfer of Corporate Bonds and Shares (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 prescribed in Article 161-2 of the Financial Instruments and Exchange Act and Security Deposits for Said Transactions (Ordinance of the Ministry of Finance No. 75 of 1953)

**Chapter 1. SESC Activity Summary****1 Overview of activities in Fiscal Year 2018**

In FY 2018 (April 2018–March 2019), various changes took place in the domestic and global economic environment surrounding Japan's securities markets. Domestically, the Japanese economy has been in a moderate recovery. Domestic demand, including consumption and investments, remained robust due to high levels of corporate earnings and improved employment and income environments. Despite the strong domestic economy, however, the outlook remained increasingly uncertain due to trade issues between large economic powers, Brexit and other causes.

Given such circumstances, in FY 2018, the Securities and Exchange Surveillance Commission (SESC) engaged in market surveillance on a timely basis, such as gathering and analyzing information from macro-economic perspectives with a focus on potential risks. In performing its monitoring and investigation duties, the SESC not only made recommendations for administrative actions and filings criminal charge against violations of regulations, but also analyzed the root-causes of the violations of regulations to prevent recurrence.

**2 Recommendations for administrative monetary penalty payment orders and filings of criminal charges against market misconduct****(1) Recommendations for administrative monetary penalty payment orders and filings of criminal charges against market misconduct**

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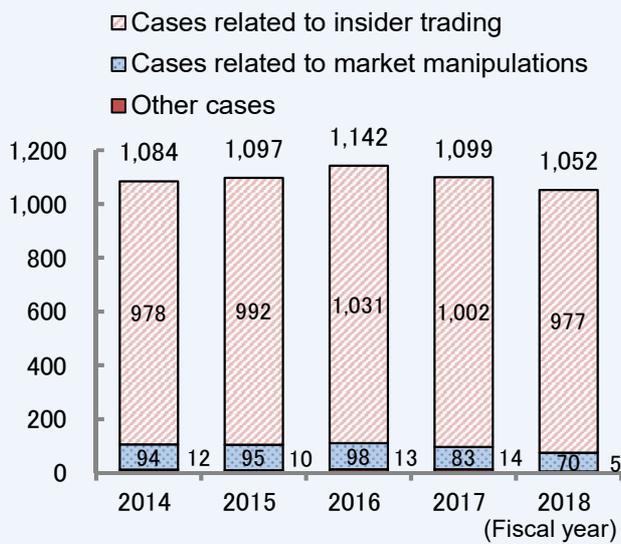
In FY 2018, the SESC made recommendations for administrative monetary penalty payment orders in 33 market misconduct cases (of which, 23 were insider trading, 7 were market manipulations and 3 were uses of fraudulent means) and filed criminal charges against 5 cases.

**(2) Case examination for detecting market misconduct**

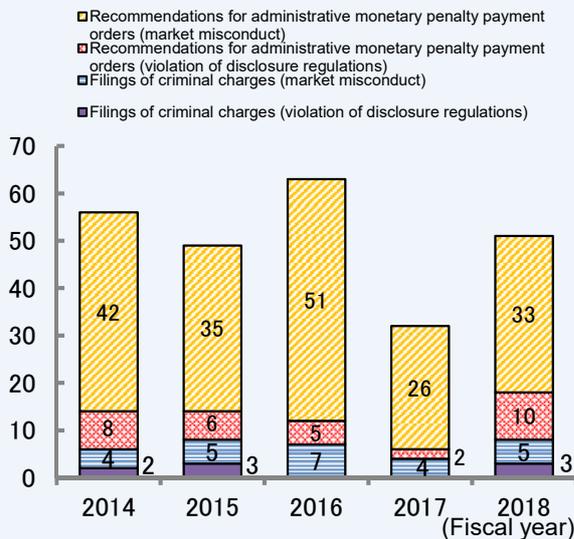
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The total number of cases examined for detecting market misconduct was 1,052 in FY 2018; over 1,000 examinations have been made for 6 consecutive years.

### Examined Cases for Market Misconduct



### Recommendations and Filings of Criminal Charges



### (3) Trends in market misconduct

Listed companies continued to reorganize themselves in various ways to improve earnings in severe business environments or as countermeasures against drastic changes in the economic situation. Under such circumstances, the SESC made numerous recommendations against insider trading where TOB, business transfer and demerger were material facts. It also made several recommendations against insider trading

where the petition for rehabilitation procedures was a material fact.

Insider trading regulations which prohibited persons from providing the insider information or making trade recommendations to others were introduced in April 2014. Since then, the first cases where the trade recommendations were the sole act of violation of the regulations were recommended for administrative monetary penalty payment orders. With regard to the regulations on the trade recommendations, quite a few listed companies still lack sufficient understandings of the regulations.

The scheme of market manipulation becomes increasingly complicated and sophisticated. The SESC made recommendations for administrative monetary penalty payment orders against cases where: in order to avoid the detection, a wrongdoer executed some spoofing orders instead of cancelling them all; in order to avoid the detection, a wrongdoer raised share prices by repeatedly buying at the basic minimum units of trade; and in order to avoid the detection, institutional investors placed spoofing orders in a night session of long-term JGB futures.

The SESC also made recommendations for monetary penalty payment orders against a unique trade method of spoofing that was aimed at eliminating trading by other investors. The method is contrary to the general spoofing, which is aimed at inducing trading orders from other investors. The

SESC deemed the method to be a use of fraudulent means.

#### **(4) Policy going forward**

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Going forward, the SESC will continue to improve its market-monitoring systems and review the methods of examination and investigation in order to keep pace with the changing economic situations and trade methods as well as to ensure flexible and efficient examinations and investigations.

The SESC will also post recommendations for administrative monetary penalty payment orders on its website as well as publish a casebook of administrative monetary penalty payment orders, which will provide information on trends and overviews of the recommendations. The casebook will also identify issues regarding internal control system that can be improved to prevent insider trading at listed companies. This effort is aimed at preventing both occurrences and recurrences of market misconduct.

### **3 Identifying and addressing violations of disclosure regulations and prevention of both occurrences and recurrences**

#### **(1) Recommendations for administrative monetary penalty payment orders and filings of criminal charges against violations of disclosure regulations**

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The SESC made recommendations for administrative monetary penalty payment

orders against 10 cases of violations of disclosure regulations and filed criminal charges against 3 cases in FY 2018.

#### **(2) Trends and causes of the violations of disclosure regulations**

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Among the 10 cases of violations of disclosure regulations against which the SESC made recommendations for administrative monetary penalty payment orders, there were misstatements in securities reports due to excessive accountings of fictitious trades in 9 cases. Of these, 3 cases involved listed companies joining the fictitious trades without appropriate confirmation and examination of the actual state of trades, resulting in the accountings of the fictitious excessive sales.

The remaining case was a violation of disclosure regulations related to non-financial information in which a wrongdoer offered stock acquisition right certificates without submitting an amendment statement for changes in a material matter concerning the offering in the securities' registration statement.

#### **(3) Policy going forward**

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The SESC will continue to gather information on listed companies and conduct analysis with a focus on the risk of fraud occurrence. It will also carry out continuous monitoring of large companies by market capitalization which are considered to have relatively large market impacts. Furthermore, the SESC will continue to gather information

and conduct analysis in light of the actual state of business, such as value chains and business customs in different industries, after selecting industries from broad perspectives in view of changes in the business environment, etc.

In addition, the SESC will engage in dialogues and enhance mutual understandings on the background and causes of the violations with the managements of listed companies that have committed violations of disclosure regulations, so as to help them build internal systems for proper information disclosure. The SESC will also proactively communicate with listed companies and audit firms regarding the details of the actual violations of disclosure regulations detected in inspections of disclosure statements. Such efforts will collectively contribute to prevent both occurrences and recurrences of violation of disclosure regulations.

#### 4 Seamless on-site/off-site monitoring of FIBOs<sup>1</sup>

##### (1) Basic monitoring policy for securities business

Since the 2016 business year<sup>2</sup>, the SESC has been conducting risk assessments of all FIBOs through off-site monitoring involving analyses of the business environment covering economic and industrial trends, as

<sup>1</sup> In this document, "FIBOs" stands for any business operator subject to securities monitoring, including Financial Instruments Business Operators, registered financial institutions, financial instruments intermediary service providers, Qualified Institutional Investor

well as the FIBOs' business models. Based on the respective risk assessments of FIBOs in the off-site monitoring, the SESC has engaged in actions to select FIBOs for on-site monitoring (on-site inspections) in collaboration with the Local Financial Bureaus.

In carrying out on-site monitoring, the SESC aims not only to point out legal problems and make recommendations for administrative actions, but also to analyze the whole picture of the problems to identify their root-causes, so that the FIBOs can design effective measures to prevent their recurrences.

In cases where the SESC identifies the issues in business control environments that need to be improved but are yet to become serious problems, the SESC has shared the findings with the FIBOs under inspection to encourage them to build effective internal control environments.

##### (2) Recommendations for administrative actions against FIBOs

In FY2018, the SESC made 11 recommendations for administrative actions against FIBOs.

These cases involved FIBOs that conducted highly problematic business practices, lacking awareness for compliance

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

<sup>2</sup> The 2016 business year refers to the period from July 1, 2016, to June 30, 2017.

and investor protection. In one case, a securities company was engaged in misstatements and misleading representations upon soliciting elderly clients to conduct switching trades of U.S. stocks. In other cases, Type II FIBOs made misstatements on their websites to solicit funds investing in loan business. There was also a case in which an investment advisor/agent made purchase recommendations simultaneously to several customers in order to trigger a sharp rise in the stock price.

### **(3) Policy going forward**

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While business operators subject to the SESC's monitoring total approximately 7,200, their size, businesses and products are diverse. Furthermore, there are business operators that are still short of the 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, in-depth examinations with regard to possible violations of relevant regulations or deficiencies in the internal control, the SESC will conduct on-site monitoring to verify the situation.

## **5 New challenges for the SESC: Initiatives for SupTech<sup>3</sup>**

### **(1) Studying the trends of financial technologies, and information gathering on the use of IT by domestic and foreign regulatory authorities**

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Advancements in IT and the convergence of finance and technology (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. In light of the situation, the SESC has set a "development of SupTech" as one of its important initiatives. Under the initiatives, the SESC studied the trends of financial technologies and gathered information on the use of IT by domestic and foreign regulatory authorities, etc. The SESC also discussed specific preparations to introduce new market surveillance systems that involve the potential use of advanced technologies such as AI (artificial intelligence).

### **(2) Policy going forward**

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The SESC will advance discussions on introducing new market surveillance systems including potential use of advanced technologies such as AI, so as to ensure effective market surveillance, by responding to changes in business processes and business models resulting from the developments of IT in financial markets.

<sup>3</sup> "SupTech" stands for supervisory technology.

Furthermore, the SESC will carefully monitor new IT advancements, such as the entry by listed companies and FIBOs into the crypto-asset business and the funding via ICOs<sup>4</sup> (Initial Coin Offerings), as these developments could affect markets in various ways.

## **6 Cooperation with relevant authorities and proactive communication with stakeholders**

### **(1) Cooperation with relevant authorities**

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The SESC works with self-regulatory organizations (e.g., Financial Instruments Firms Associations, Financial Instruments Exchanges, and Japan Exchange Regulation, hereinafter “SROs”) on a daily basis in examining market transactions and in monitoring the appropriateness of members’ operations. The SESC further strengthened its cooperative relationship with SROs through periodic discussions to share emerging issues related to market surveillance. In FY 2018, the SESC had such periodic discussions with SROs (18 times) as well as FIBOs and relevant authorities to exchange views.

In terms of cooperation with foreign authorities, the SESC participates in a variety of multilateral discussions at IOSCO and actively engages in exchanges of views on a bilateral basis. On top of that, in the cases of investigations into market

misconduct using cross-border transactions, the SESC made a total of 23 requests for information to foreign authorities through the IOSCO MMoU (Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information) in FY 2018.

### **(2) Proactive communication with stakeholders**

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The SESC continuously endeavors to enhance its external communications by making the information more specific and easier to understand. The SESC provides retail investors and other market participants with significance and root-causes of the cases as well as activities of the SESC at various occasions. This includes the publication of individual cases at the time of recommendations, publication of casebooks of administrative monetary penalty payment orders and FIBOs monitoring results, as well as the contribution of articles and lectures. In FY2018, the SESC proactively communicated through the website, etc., and the SESC representatives also spoke at a total of 28 seminars to market participants, certified public accountants, lawyers, and other attendees.

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<sup>4</sup> “ICOs” are generally regarded as a catch-all term for the electronic issuance of tokens by companies in

order to procure currency or crypto-assets (cryptocurrency) from the general public.

## **FY2018 KEY TOPICS (1)**

### **Policy proposals in light of timely inspections and the results of the inspections of funds investing in loan business (social lending)**

- Improvement of information provision and explanations to investors about borrowers

Funds investing in loan business are those lending money provided by investors. Among such funds, the practice of so-called “social lending” (loan-based crowd funding), which involves soliciting investors via the Internet, has increased in recent years. With respect to the crowd funding, certain measures have been taken with the aim of encouraging the provision of risk money.

Against this background, the SESC and Local Finance Bureaus have been conducted off-site monitoring to confirm whether the business invested by the funds actually exists, and to investigate rationale of the funds’ high dividend yields among others. The SESC has also conducted on-site monitoring (on-site inspections) of the fund considered to be high risk where necessary. As a result, the SESC has uncovered FIEA breaches and malicious cases that have harmed investors. For example, it was uncovered that some sellers were

- making false statements about the use of funds,
- making misleading statements about borrowers, collateral, etc., and
- continuing to solicit investors despite knowing that borrowers’ financial situation would make it difficult for them to repay their loans.

Therefore, the SESC made recommendations for administrative disciplinary action against these cases (see 2-2-3 in the main report). In this way, the SESC and Local Finance Bureaus are responding as necessary to protect investors.

Furthermore, in addition to legal violations by sellers, the SESC’s inspections have also revealed a need for improvement in the operation of

the funds themselves. Specifically, some of them were holding back information that would allow fund investors to identify the borrowers. This occurred because if the information that could be used to identify borrowers were disclosed to investors, the act of investing money in the fund would fall under “lending” as defined in the Money Lending Business Act, which may require the investors to register as a money lending business under the Act. As a result, they had kept borrowers’ information anonymous or pooled loans so as to prevent identification of borrowers, but such practices ultimately limited information that investors can obtain when they make investment decision. Inspections conducted by the SESC and Local Finance Bureaus have highlighted the need for improvements in this area.

Given that the provision of information for investors’ decision making was considered inadequate, in December 2018, the SESC made policy proposal (expressions of opinion based on the law) to the Prime Minister and the Commissioner of the Financial Services Agency (FSA) (see 2-7-3 in the main report). The proposal was as follows: “From the standpoint of further improving the protection of investors in funds investing in loan business, appropriate action needs to be taken, such as providing investors with information and expanding explanations for their proper investment decision making.”

In March 2019, the FSA announced that in order to provide more information to investors, if certain conditions are met (Note 1), money lending business registration by investors would be deemed unnecessary even if sellers disclose information on borrowers to investors (Note 2). Furthermore, in May 2019, the Japan Financial Services Association and the Type II Financial Instruments Firms Association published a “Q&A of the Fund investing in Loan Business” to highlight points to keep in mind with regard to the provision of information by the funds. As a result of these initiatives, it is expected that more information provision and explanations to investors concerning funds investing in loan business will be provided to investors.

In this way, based on the results of its inspections and investigations,

the SESC makes a policy proposal to the Prime Minister and the Commissioner of the FSA concerning measures that it deems necessary for the protection of investors. By this policy proposal system, the SESC will continue to proactively contribute to improving the market environment.

Note 1: The business scheme employed by funds investing in loan business is based on a Silent Partnership Agreement, and steps are taken to prohibit contact between investors and borrowers.

Note 2: The Plan for Regulatory Reform, which was approved by the Cabinet on June 15, 2018 also contained the following statement: "The adoption of new measures should be considered that would be implemented concurrently with anonymity and pooling, which have thus far been deemed sole factors in making it unnecessary for investors to register as a money lending business, while also taking into account the attributes of borrowers."

## FY2018 KEY TOPICS (2)

### **Monitoring of all transactions including listed derivatives**

- Recommendations for administrative monetary penalties payment orders and recommendations for administrative disciplinary action in cases of manipulation of market for long-term government bond futures by institutional investors

In our policy called "Strategy & Policy of the SESC 2017-2019," the SESC declared as a strategic objective the comprehensive monitoring of all transactions and markets, not only spot market, but also PTS (private transaction systems), dark pools, derivatives, and stock/bond issuance markets, and has been pursuing this objective since then. It has also been working with relevant organizations such as self-regulatory organizations (e.g. Japan Exchange Regulation) and foreign authorities to turn the spotlight not only on domestic investors but also on the actions of overseas investors.

In FY2018, we issued two recommendations for administrative monetary penalties payment orders and one recommendation for administrative disciplinary action against the cases of spoofing, attempting to manipulate prices through spoofing orders in the long-term government bond futures markets. The wrongdoers engaged in the improper conducts as employees at a large securities firm and an offshore financial institution.

- 
- Manipulation of market for long-term government bond futures by a large securities firm.  
(Recommendation for administrative monetary penalty payment order, June 2018)

Case of a manipulation in the long-term government bond futures listed

on the Osaka Securities Exchange by a dealer at a large securities firm in August 2017. The monetary penalty was 218,370,000 yen (the biggest fines ever for case of manipulation of the listed derivatives by a securities firm). The investigation was supported by the information provided by Japan Exchange Regulation.

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- Manipulation of market for long-term government bond futures by an offshore financial institution  
(Recommendation for administrative monetary penalty payment order, March 2019)
  - Deficiencies in trading control environment at a group securities firm undertaking transactions relating to the market manipulation  
(Recommendation for administrative disciplinary action, April 2019)
- 

Case of a manipulation in the long-term government bond futures listed on the Osaka Securities Exchange by a dealer at a financial business operator based in the U.K. and registered with the U.K. financial authorities in October 2018. The monetary penalty was 133,370,000 yen. The investigation was supported by the information provided by Japan Exchange Regulation.

In addition to the recommendation for administrative monetary penalty payment order, the SESC also made a recommendation for administrative disciplinary action against a group securities firm, on the grounds that it undertook and executed the market manipulation by overlooking the suspicious transactions due to deficiencies in its transaction system, trade review system, and trading control environment.

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In this way, the SESC keeps a close eye on what is happening in the markets, and through working with SROs and foreign authorities, will take

appropriate action against any violation of regulations observed in the markets.

## 2-1 Case examination, collection/analysis of wide-ranging information

### 1. Purpose of market surveillance

To realize holistic and timely market oversight corresponding to the changing market environment, market surveillance is positioned as the entrance for information at the SESC. This is because the surveillance aims at not only collecting and analyzing an extensive range of information on overall financial and capital markets, but also detecting any suspected market misconduct through monitoring the primary and secondary markets.

For the above reason, the SESC daily receives a wide range of information from investors and others, and promptly circulates the information to the relevant divisions within the SESC (or the relevant division within FSA, if the information relates to affairs under the jurisdiction of the FSA). The SESC also cooperates with SROs to gather a variety of information related to financial and capital markets. Based on the 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 identified.

Recently, the SESC also closely monitors crypto-asset-related businesses operated by listed companies and their affiliated companies, in cooperation with the relevant divisions within the FSA and Financial Instruments Exchanges (FIEs).

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

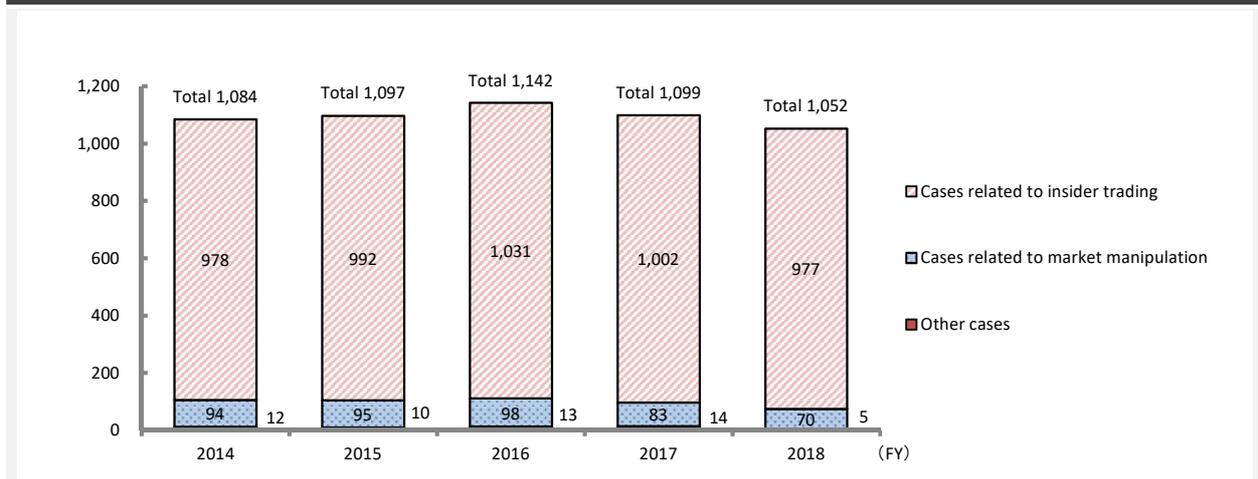
### 2. Status of case examinations

Changes in the external environment, including macro-economic 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 transaction cases the SESC examined to detect suspicious market misconduct reached 1,052 in FY2018, the same level as FY2017. Over 1,000 case examinations have been made annually for 6 consecutive years.

The 1,052 transactions reviewed by the SESC consist of suspected insider trading (977), suspected market manipulation (70) and others, including use of fraudulent means and spreading of rumors (5).

In response to the revised FIEA, which includes the introduction of rules on high-speed transactions (e.g. registration of parties engaging in high-speed transactions and the clarification of transaction strategies) and came into effect in April 2018, the SESC focused on fact finding for an effective monitoring of transactions. Specifically, the SESC analyzed transactions by, for example, examining orders placed and executed by parties engaging in high-speed transactions.

**Fig. 2-1-1: Examined cases for market misconduct**



### 3. Overview of market monitoring

To conduct market oversight in a holistic and timely 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 and whistleblowing

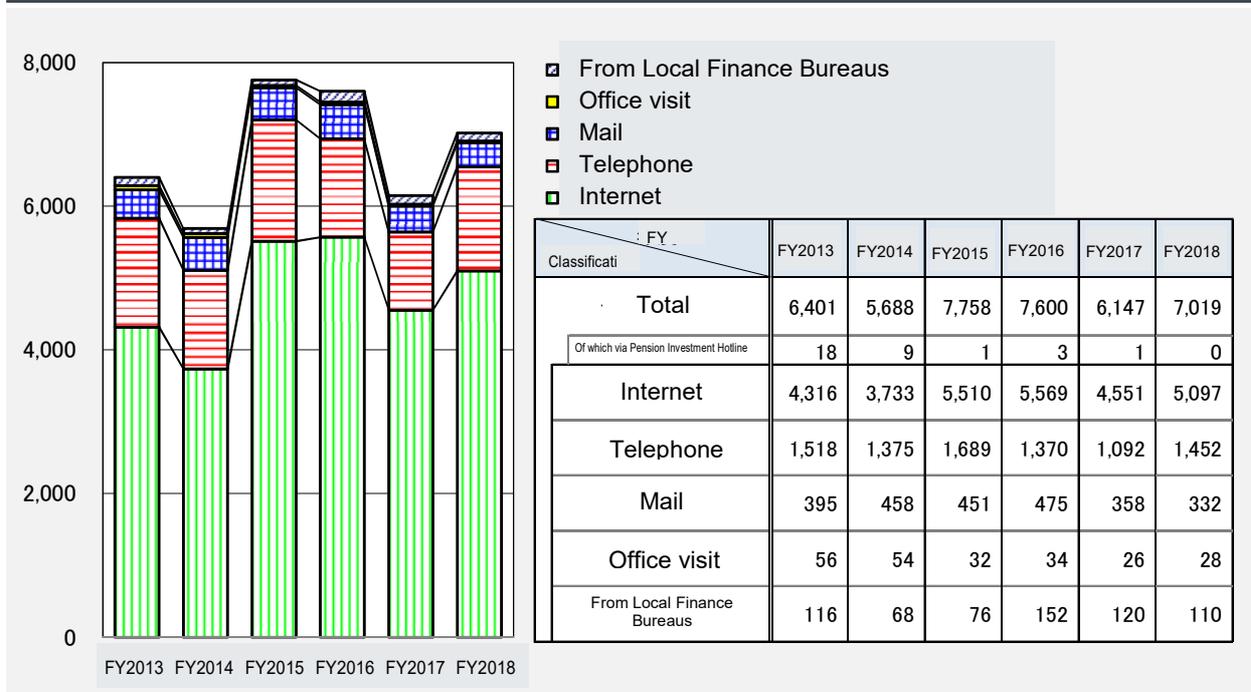
##### (i) Efforts to collect information

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

To this end, in FY2018, the SESC continued active efforts to collect information. For example, to collect more useful information provided via the Internet, the SESC improved the information entry window on its website, and urged individual investors to provide information by distributing posters and leaflets carrying QR codes. Also, to collect information before opening of stock markets, operating hour of the phone line for receiving information started at an earlier time. In FY2018, the SESC received 7,019 reports from public.

The SESC also provides preparatory consultation to whistleblowers through a dedicated Contact Point for Whistle-blowing and examines the contents of the information before formally accepting it. In FY2018, two tips from whistleblowers were accepted. The SESC utilizes information even if it does not fall under the definition of whistleblowing.

Fig. 2-1-2: Number of tips received



## (ii) Use of collected information

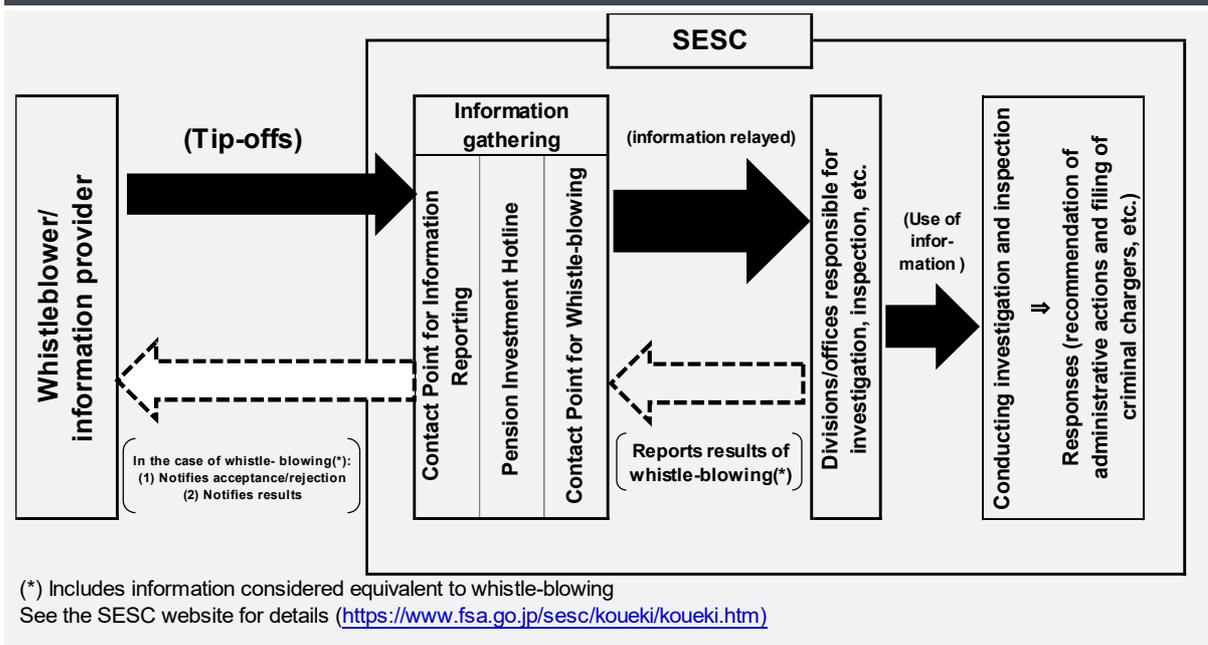
Information/tips on suspected market misconduct are examined at the Contact Point for Information Reporting and relayed to the responsible divisions in the SESC for inspection and investigation.

For example, a case of insider trading was found based on an investigation triggered by a reported information 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.

As the information/tips on suspected market misconduct are more useful when they are current and specific, the SESC asks readers of this report to refer to examples provided on the SESC website<sup>6</sup> to learn about the details of the formation provision. The SESC will continue its efforts to gather a wide range of highly useful information.

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

Fig. 2-1-3: Flow of information



## (2) Market trend analysis

In addressing cases of “fraudulent finance,”<sup>7</sup> 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 and relevant officials at Local Financial Bureaus and FIEs. As a result, some listed companies have been forced to delist or been expelled from the capital market since they have released false information in connection with the issuance of new stocks or stock acquisition rights allocated to third parties. As there are emerging cases in which problematic companies try to hide market misconduct by complex finance schemes or by issuance of shares to overseas funds, the SESC will keep a close eye on these activities.

Further, given recent developments, such as listed companies or their affiliates entering crypto-asset-related businesses, the SESC will continue, in cooperation with the FSA’s relevant divisions and FIEs, to monitor market trends carefully, specifically from the perspective of monitoring listed companies’ market misconduct.

Furthermore, in FY2015, the SESC established the system that enables its staff to make use of centrally-managed information that has been gathered and analyzed in the course of market monitoring. In FY2018, the SESC expanded the range of information gathered as well as

<sup>7</sup> “Fraudulent finance” is a series of fraudulent trading practices comprised of inappropriate acts in the primary or secondary market.

advanced discussion and considered future database that would allow information to be utilized in multi-faceted and multi-lineal ways across all monitoring operations of the SESC.

### (3) Forward-looking analysis

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

For FY2018, the SESC analyzed individual companies that were selected considering economic trends, earnings trends and other factors. In doing so, the SESC collected information through interviews with the assistance of private-sector analysts. The SESC shared the results of the analyses within the organization and with the FSA's relevant divisions.

## 4. Future challenges

### (1) Effective and sophisticated monitoring of high speed trading

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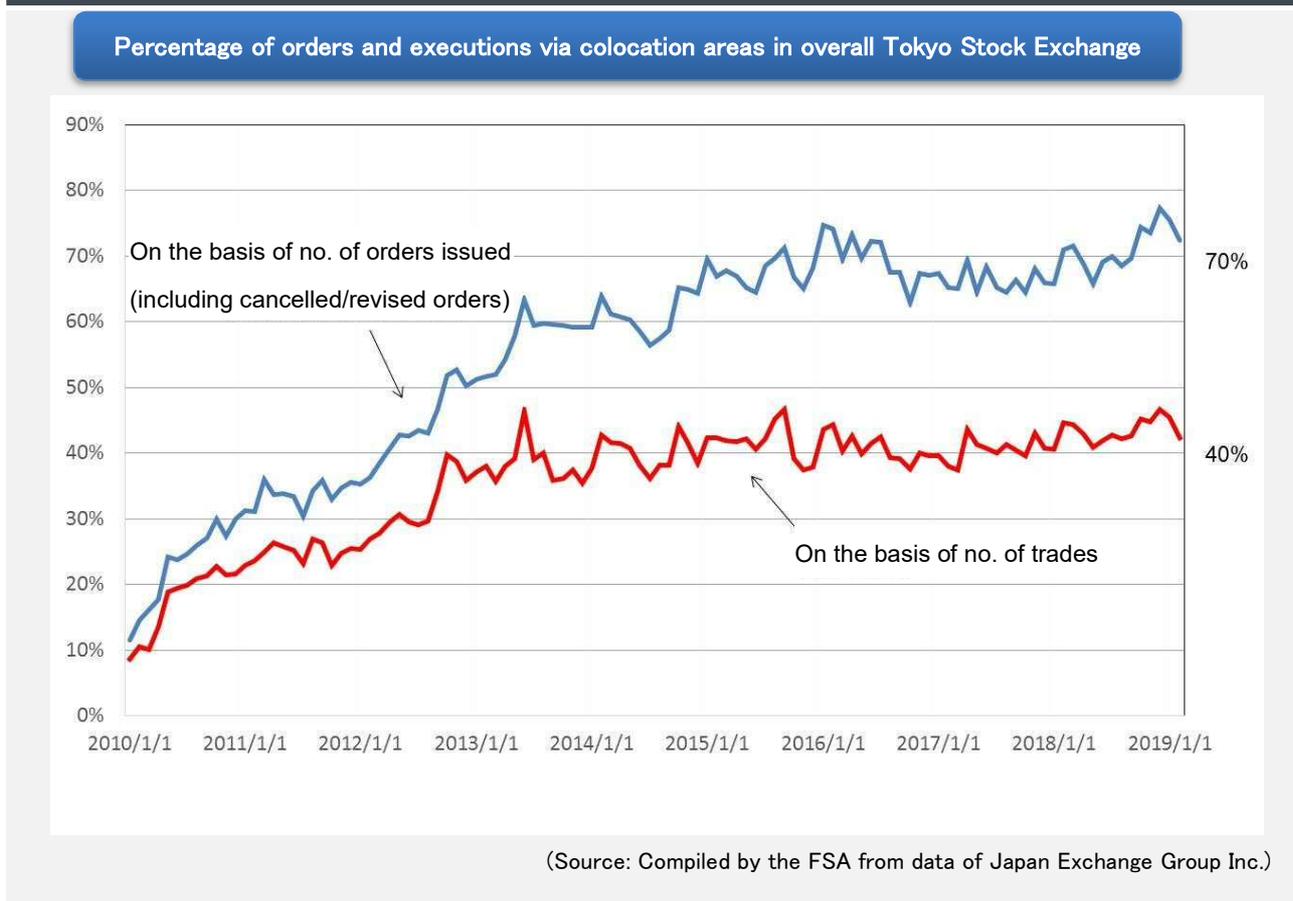
In recent years, the share of HSTs via the Tokyo Stock Exchange's colocation areas<sup>8</sup> has remained high in terms of both orders (70%) and executions (40%) (See Fig. 2-1-4).

Under such circumstances, the SESC, based on information provided by FIEs, etc., will continue to identify and analyze the characteristics of orders and executions by HST operators. The SESC will also share information and exchange opinions on HST operators with the FSA's relevant divisions and FIEs, and explore more efficient and sophisticated surveillance of HST.

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<sup>8</sup> Trading facilities set up adjacent to the exchange's trading system. Investors can shorten the time it takes to execute transactions by orders from servers set up in these facilities.

Fig. 2-1-4: Increase in HST



## (2) Sophistication of analysis from forward-looking perspectives

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

With transactions becoming more sophisticated and complex, and new financial instruments and transactions being developed in recent years, 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, it is necessary to have a mechanism in place that can collect and search for data required for confirmation and analysis more efficiently and effectively. The SESC will address these issues by further utilization of information technology.

#### (4) Promotion to increase receipt of information and whistleblowing

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To promote reporting of useful information to the SESC, it will endeavor to increase the level of public recognition regarding the “Contact Point for Information Reporting” through identifying new counterparties to display posters and distribute leaflets for the SESC. Further, so as to make reporting to the SESC more convenient and increase the reported information, the SESC will move forward with setting up a website to receive information via smartphone.

## Case Study

# Report Suspicious Transactions!

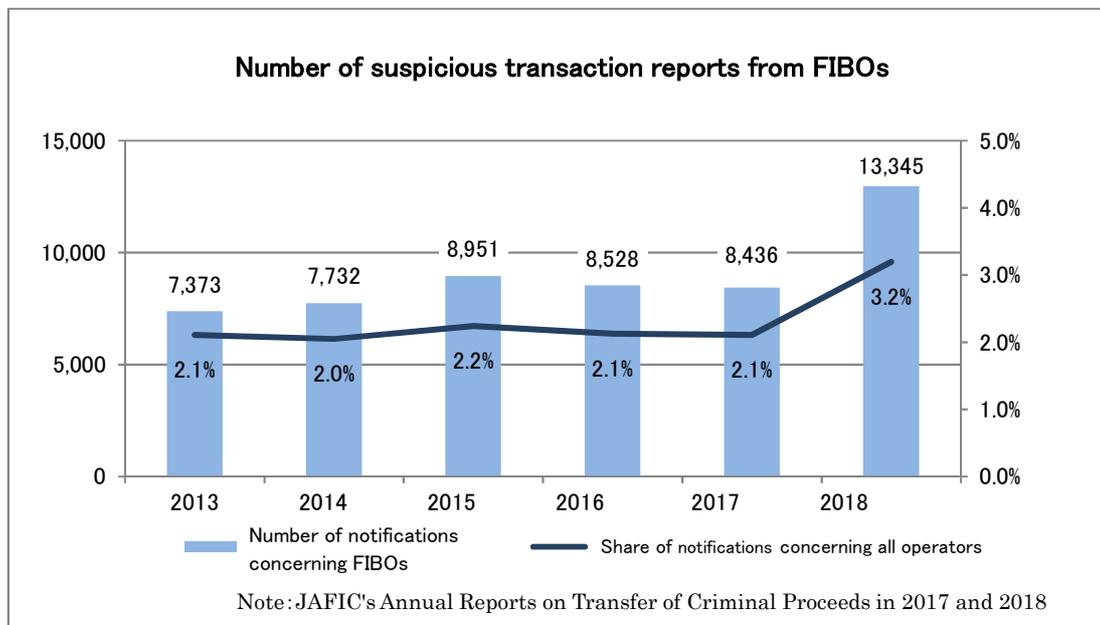
## < Message to Financial Instruments Business Operators (FIBOs) >

### ➤ Importance of reporting suspicious transactions

- ✓ When FIBOs discover transactions that are suspected to be related to revenue from crime, they must report them to the competent authority (the FSA).
- ✓ This reporting of suspicious transactions not only initiates investigation of cases, but is also useful for discovering assets deprived by crime and for identifying sources of funding for organized crime groups, such as anti-social groups. It therefore provides a valuable source of information for tackling organized crime and plays a key role in dealing with money laundering.

### ➤ Reporting of suspicious transactions

- ✓ The SESC has been active in providing guidance to FIBOs on tackling money laundering. While reports from FIBOs do not account for a large proportion of the total number of suspicious transactions reports, the level of understanding among FIBOs has improved, and in 2018 the number of reports from FIBOs increased by around 60% compared with the previous year. However, as some FIBOs only report transactions they have identified merely based on mechanical criteria and without examining the details, the SESC intends to provide guidance to improve the content of the reports.



➤ **Revision of reference cases of suspicious transactions**

- ✓ Taking into account the current situation regarding anti-money laundering, in April 2019, the FSA revised its reference case book of suspicious transactions by adding, for example:
  - Cases relating to risks identified by National Risk Assessment of Money Laundering and Terrorist Financing
  - Cases focused on technology and cybersecurity
  - Cases relating to reports and guidance from FATF (Financial Action Task Force: intergovernmental body for promoting international cooperation in such areas as tackling money laundering)
- ✓ Inspections conducted in FY2018 revealed cases where the management environment for reporting suspicious transactions was inadequate. Given that the money laundering risk in the securities sector is not low at all, FIBOs need to report all suspicious transactions by identifying them more accurately based on the results of analysis of these reference cases and cases they themselves have experienced and accumulated.

## 2-2 Monitoring of financial instruments business operators

### 1. Purpose of monitoring securities businesses

The SESC accurately recognized 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, where necessary, recommends that the Prime Minister and the FSA Commissioner take appropriate measures or provides necessary information to the supervisory departments in the FSA. The purpose of monitoring securities businesses is to encourage FIBOs to establish proper governance and risk management environments, administer their businesses in accordance with laws, regulations, and market rules, and perform their function as market intermediaries appropriately, for example, as gatekeepers, and maintain a market environment in which investors are able to invest comfortably.

### 2. Changes in environment surrounding financial instruments business operators

In FY2018, various changes took place in the domestic and international economic environment surrounding Japan’s securities markets. Although the world economy was experiencing a moderate recovery, notable changes occurred in Europe and US. For example, unusual monetary easing that had been introduced following the financial crisis began to be wound down, while stock prices, which had remained strong, plunged.

Regarding trends in domestic financial and capital markets, stock prices remained at high levels, but the pace of the stock-price appreciation slowed, so did the rate of increase of trading volume. Interest rates, meanwhile, stayed at historically low levels.

Against this background, certain investors began seeking high-yield products, and there were some cases where retail investors bought high-risk financial instruments without being fully informed of the risks, which led to problems. There were also incidents of unregistered FIBOs causing investors to suffer losses after claiming high rates of returns.

In addition, cyberattacks remain a threat to FIBOs, and there was a case of a regional securities firm having its website tampered as a result of a cyberattack that exploited vulnerabilities in the site. It is therefore imperative for FIBOs, regardless of their size, to establish appropriate IT risk management environments.

### 3. Achievements of monitoring (risk awareness)

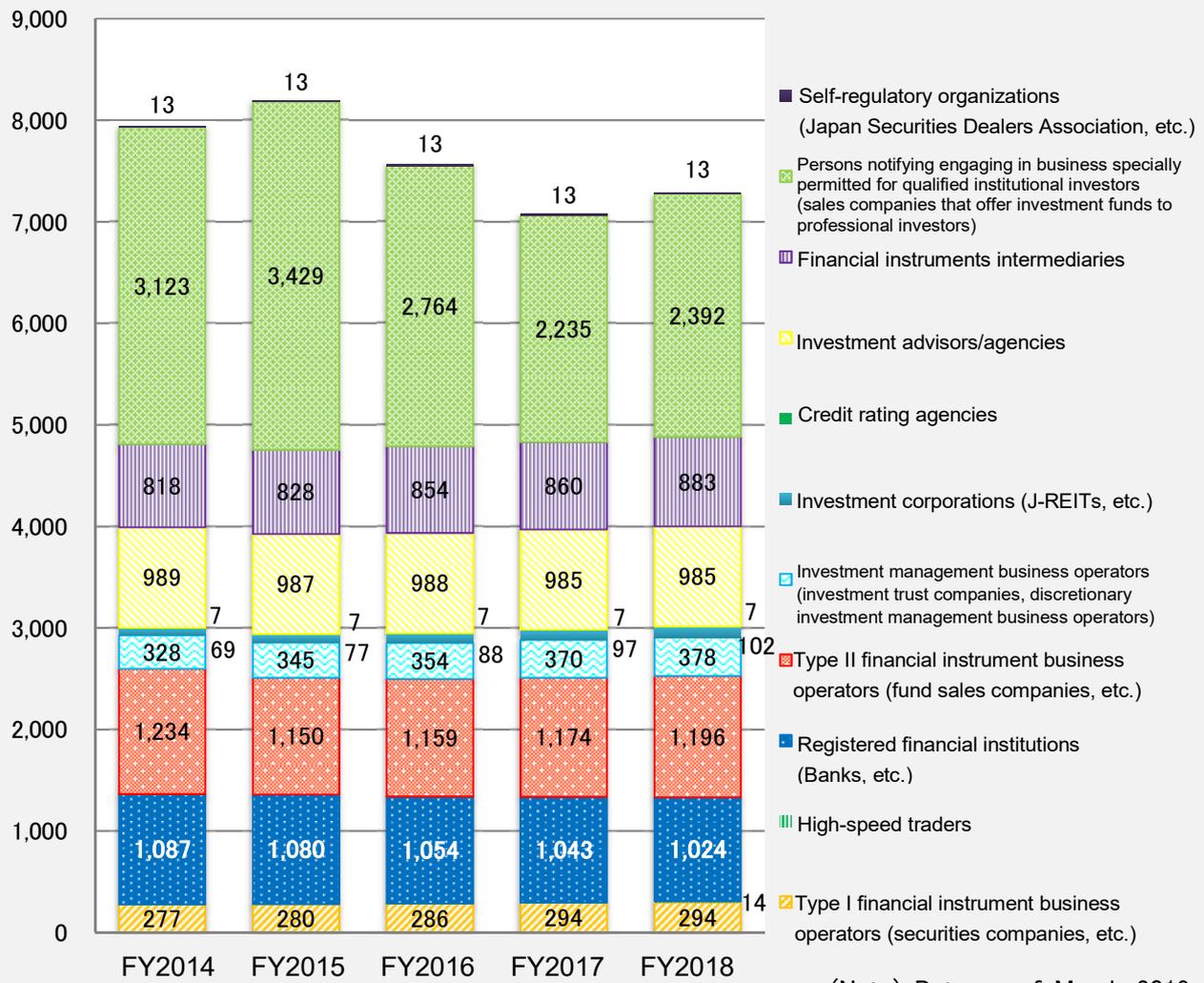
The number of FIBOs subject to the SESC's monitoring is approximately 7,200 in total, and their size, service details and product offerings vary widely. Some of these FIBOs have not had adequate awareness towards and systems for legal and regulatory compliance and investor protection. As such, it is important to monitor them efficiently and effectively so as to identify their risks considering each characteristic of FIBOs by analyzing macro-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 scales, types, 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 in the on-site monitoring using multi-faceted risk evaluation, the SESC selected the FIBOs subject to on-site monitoring. In our on-site monitoring, the SESC conducted in-depth analysis of the FIBOs' products and trading schemes and then examined the appropriateness of their business operations. When problems were detected, the SESC further looked into their root causes, and made recommendations for administrative disciplinary actions or informed them of issues relating to their business operations.

The SESC also communicated with Local Finance Bureaus on a daily basis, and shared relevant information with them in a timely fashion. It also proactively provided advice and guidance to Local Finance Bureaus with respect to their on-site inspections.

Fig. 2-2-1 Number of FIBOs subject to monitoring



**Fig. 2-2-2 Summary of monitoring priorities for securities businesses for 2018 business year<sup>9</sup>****Basic monitoring policy**

- Continue implementing a strategy of selecting the businesses subject to on-site monitoring based on the off-site risk assessment of all securities businesses, which will be carried out in collaboration with the relevant bureaus of the JFSA and include an analysis of the business environment covering economic and industrial trends and an entity's business model.
- Analyze the whole picture of the problems and identify their root cause through on-site monitoring to develop effective recurrence prevention measures. Also, urge securities business to improve business operations if they have potential issues which may not necessarily have become materialized problems.

**Activity policy for the current business year**

- Assess risks focusing on FIBOs' move to change the traditional business models that relies on fee income by, for instance, starting new businesses and expanding their product lineup in response to investors' expectations for higher-return products.
- Proactively conduct on-site monitoring for in-depth examinations in the current business year particularly if any of the following situations is identified:
  - a relevant law and/or regulation is breached or there is a deficiency in business operations that requires a prompt in-depth examination;
  - a financial instrument is offered with an unclear risk profile, necessitating an examination of its solicitation activities;
  - the actual situation of business operations is not fully comprehended from an information analysis based on off-site monitoring (including where there is a long period between examinations); and
  - there is a possible serious problem concerning investor protection (e.g. inadequacy in the segregated management of customer assets).
- In addition to the above, actively collect and analyze information on unregistered business operators, conduct investigations in collaboration with relevant agencies, and seek court injunctions to cease and suspend the violations.

(Released September 2018)

**(1) Securities companies**

In FY2018, the SESC conducted risk assessment of securities companies, focusing on their expansion of products (e.g. overseas financial products and high-yield funds in response to investors' expectations for high-yield products) and changes in their business models (e.g. expansion into new fields of business). Furthermore, due to concerns about specific cases of legal violations and business administration environments, the SESC conducted proactive on-site monitoring of, for example, companies required in-depth investigation at an early stage and companies required investigation of their marketing of products whose risks are unclear.

The following table shows challenges and risks identified in the monitoring related to business operations by business scales and types of securities companies.

<sup>9</sup> The 2018 business year refers to the period from July 1, 2018 to June 30, 2019.

## Challenges and risks related to business operation:

<b>Major securities companies</b>	<ul style="list-style-type: none"> <li>• It is important to perform governance functions to establish a foundation for stable earnings and finances that is not easily affected by market and economic trends</li> <li>• It is essential to make risk management systems even more sophisticated to support global business development</li> <li>• It is essential to establish effective compliance environments by, for example, going beyond legal requirements and reviewing various measures on the basis of principles</li> <li>• To fulfill true fiduciary duty, it is essential to properly segment customers and to develop and assign personnel to each segment</li> </ul>
<b>Banking groups</b>	<ul style="list-style-type: none"> <li>• There are potential risks such as conflict of interests related to the combined promotion by banks and securities companies</li> <li>• An urgent task is to make group-level AML<sup>10</sup>/CFT<sup>11</sup> control more sophisticated</li> </ul>
<b>Foreign securities companies</b>	<ul style="list-style-type: none"> <li>• There are risks in assessing the suitability of clients' profile to the offered derivatives in Japan under continuing low interest rates environment</li> <li>• Operational risks are stemming from technological deployment and offshoring to improve business efficiency</li> </ul>
<b>Online securities companies</b>	<ul style="list-style-type: none"> <li>• Management of face-to-face sales needs to be strengthened in conjunction with business expansion as IFAs (independent financial advisors) or brokers for registered financial institutions</li> </ul>

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<sup>10</sup> Anti-Money Laundering

<sup>11</sup> Counter Financing of Terrorism

	<ul style="list-style-type: none"> <li>Proper explanations to customers are required in conjunction with the introduction and expansion of new investment methods such as robot advisors</li> </ul>
<b>Regional securities companies</b>	<ul style="list-style-type: none"> <li>There are risks arising from handling diversified financial instruments without establishing sufficient sales management systems when pursuing sales expansion</li> </ul>

Furthermore, given that cyberattacks still pose a threat to FIBOs, in FY2018 the SESC conducted a fact-finding survey on cyber-security measures taken not only by securities companies and FX dealers, but also PTS operators and investment management business operators.

It was found in the survey that some FIBOs were not well-prepared for cyber-security issues due to the management's lack of awareness. The SESC provided the results of the analysis to them and urged them to take adequate measures.

Of the 32 securities companies that were subjected to on-site monitoring in FY2018, the SESC notified 19 about their problems found in the monitoring, and made recommendations for administrative disciplinary actions on 2 that committed serious breaches of laws and regulations, such as making misstatements or misleading representations about important matters to customers.

#### Key Cases:

Company name	Date of recommendation	Description
Toyo Securities Co., Ltd.	October 30, 2018	In an effort to encourage customers to switch to U.S. stocks, numerous sales staff made misstatements and misleading representations. These included understating actual losses with the U.S. stocks they were selling or stating that profits were being made when in fact losses were being incurred.

## 2-2 Monitoring of financial instruments business operators

CLSA Securities Japan Co., Ltd.	January 25, 2019	With regard to orders received from overseas-based corporate customers for short selling of exchange-traded financial products, the company executed multiple long-term short-selling orders without confirming that securities lending contracts for the short sales had been concluded or that other steps had been taken to ensure delivery of the securities. Furthermore, with respect to trade examination aimed at preventing manipulation to create artificial prices, the company significantly limited the transactions subject to trade examination, and did not even examine those transactions that had been selected.
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(2) Investment management business operators

In monitoring investment management business operators, from the view point of conflict of interests management, the SESC performed on-site monitoring of investment management business operators that are affiliated with large corporate groups, investment management business operators that do not invest in their own account, and private REIT operators. Among these, the on-site monitoring also targeted investment management business operators that had never been subject to inspections before.

Furthermore, the SESC engaged in dialogue, mainly with large investment management business operators, on challenges for “making the asset management business more sophisticated,” which was included in the FSA’s “For Providing Better Financial Services in the Era of Transition – Financial Services Policy: Assessments and Strategic Priorities 2018.” Through this dialogue, it was confirmed that three tasks need to be tackled: (1) strengthen global management structures, (2) develop and secure investment experts, and (3) establish infrastructure and platforms.

### (3) Type II financial instruments business operators

Regarding Type II FIBOs, which include funds investing in loan business, the SESC conducted off-site monitoring focusing on funds claiming high yields and on whether businesses invested in actually exist. The SESC also timely conducted immediate on-site monitoring of operators considered to be carrying high risk based on analysis of information submitted by investors. In the case of funds investing in loan business, the SESC identified multiple FIEA violations and malicious incidents that had caused losses of investors. These included misstatements about how lent money is going to be used, and misleading statements about borrowers and collaterals. Some fund kept soliciting investors despite knowing that the financial condition of borrowers would make it difficult for them to repay the money they had borrowed from the fund.

Background factors in these cases likely included inadequate legal compliance by the sellers of the funds as well as holding back information that would allow funds investors to identify borrowers. This was occurring because if information that would be used to identify borrowers were disclosed to investors, the investors might have to register as a money lending business. In light of this situation regarding the provision of information to investors, the SESC made policy proposal to the FSA: “From the standpoint of further improving the protection of investors in funds investing in loan business, appropriate action needs to be taken, which would enable providing investors with information for making proper investment decisions and expanding explanations”.

Of the 7 operators that were subjected to on-site monitoring in FY2018, the SESC notified 5 about problems found in the monitoring and made recommendations for administrative disciplinary actions on 4 that had committed serious breaches of laws and regulations.

#### Key Cases:

Company name	Date of recommendation	Description
maneo Market Inc.	July 6, 2018	Regarding a fund that was soliciting investors via the company’s website, the company did not confirm whether the purpose of use of funds stated on the fund’s website was the same as the actual use of funds, and

## 2-2 Monitoring of financial instruments business operators

		investors continued to be solicited based on the statements that differed from the facts.
Ai Trust Co., Ltd.	December 7, 2018 February 22, 2019	Using its own website, the company solicited investment for fund (a silent partnership) in which the company was the business operator, and used the money invested to make loans to corporations. When soliciting investment for their fund, it made false statements. For example, it stated that it would invest in a business that did not actually exist.

**(4) Investment advisors/agencies**

The SESC monitored investment advisors/agencies to confirm that they were not using misleading advertising to customers or soliciting customers based on false explanations. We also conducted on-site monitoring on the advisors/agencies considered to carry high risk. The SESC found that with respect to the buying and selling of securities, some investment advisors/agencies advised customers to engage in transactions where prices would be determined artificially.

Of the 6 investment advisors/agencies that were subjected to on-site monitoring in FY2018, the SESC notified all 6 about their problems found in the monitoring and made recommendations for administrative disciplinary actions on 5 that had committed serious breaches of laws and regulations.

**Key Cases:**

<b>Company name</b>	<b>Date of recommendation</b>	<b>Description</b>
AK Advisors Co., Ltd.	May 22, 2018	The company, in cooperation with a group company, make purchase recommendations simultaneously to several customers in order to trigger a sharp rise in the stock price and to show its advanced analysis capabilities of

## 2-2 Monitoring of financial instruments business operators

		stock market to customers possessed superior stock analysis capabilities.
Delta Investment Co., Ltd.	October 30, 2018	Using its own name, the company made an unregistered operator that was essentially run by the representative of the company provide investment advice as an agency by sending emails containing the timing and prices of trades relating to options transactions and FX margin transactions.

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

To prevent damage to investors from fraud caused by unregistered business operators, the SESC took actions against unregistered business operators rigorously by asking court to grant an injunctions in cooperation with the FSA, Local Finance Bureaus and other investigating authorities. As necessary, the SESC publicly disclosed the name of the unregistered business operator, the name of the representative, and a description of the legal and regulatory violations.

## Key Cases:

Defendant	Date of petition (name of court)	Description	Issue date
Orange Plan Co., Ltd., Goldmine Co., Ltd., and two individuals	May 29, 2018  (Tokyo District Court)	The companies sold a financial product called "Portfolio Coin" and they explained that the overseas company issuing Portfolio Coin distributes the investment returns of crypto-assets to the buyers of Portfolio Coin the defendants, which include the companies, solicit investors in Portfolio Coin by meeting with investors, organizing seminars, and running email campaigns, and have sold, in total, at least around 3.1 billion yen's worth of Portfolio	July 27, 2018  (Tokyo District Court)

## 2-2 Monitoring of financial instruments business operators

			Coin to approximately 8,100 individual investors. In other words, they have conducted unregistered Type II financial instruments business.	
Clover Asset Management Inc., J Trust Co., Ltd., and two individuals	November 16, 2018 (Tokyo District Court)		The companies solicited investors in products called “Clover Membership,” “J Trust Membership,” “Yotsuba MRF Account,” and “J Trust MRF Account” by telephoning individual investors, and conducted unregistered Type II financial instruments business by obtaining investments worth a total of around 1.8 billion yen from a total of approximately 220 individual investors.	January 11, 2019 (Tokyo District Court)

**(6) Issues requiring attention**

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

As such, in cases where the SESC identifies the issues in business control environments that need to be improved but are yet to become serious problem, the SESC has shared the findings with the FIBOs under the on-site monitoring to encourage them to build effective internal control environments.

Example cases:

**(i) Sustainability of business model**

With the declining number of new customers, and aging of existing customers and employees, the company’s operating revenues are stagnant. The company’s management is aiming to keep the business operating stably over the medium to long term, but has not considered any specific measures for doing so. Given this situation, the management needs to first clarify the challenges the company is facing and then move quickly to consider and

implement measures for keeping the business operation stable over the medium to long term.

(ii) Inadequate checks on Director/COO

The COO, who is also a board director, is the sole person handling important tasks such as the management of compliance, market risk, and liquidity risk. The person also plays the central role in the business operation of the company by providing guidance to and overseeing the various departments in the company as the COO. The company is thus dependent on the judgement and management of this single individual with respect to the company's operation, and no effective measures to enable other directors to check business execution by the COO have been put in place. The company also needs to consider establishing a back-up system for responding in the event that the COO is unable to execute the company's business.

## 4. Future challenges

### (1) Enhancing monitoring of securities business

While business operators subject to the SESC's monitoring total approximately 7,200 after the enactment of the FIEA, their size, businesses and products are diverse. Furthermore, there are business operators that are still short of the fundamental awareness and controls for compliance and investor protection. To conduct monitoring of FIBOs 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 brush up securities business monitoring so that challenges and problems FIBOs are facing 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-," which was published in FY2018.

### (2) Enhancing feedback

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

2-2 Monitoring of financial instruments business operators

of recognized issues and provide feedback for business operators to encourage them to develop effective preventive measures.

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



**Do you know about regulations on the trade recommendation?  
– Even if you don't convey insider information, it may still be  
against the law!**

<Message to corporate members>

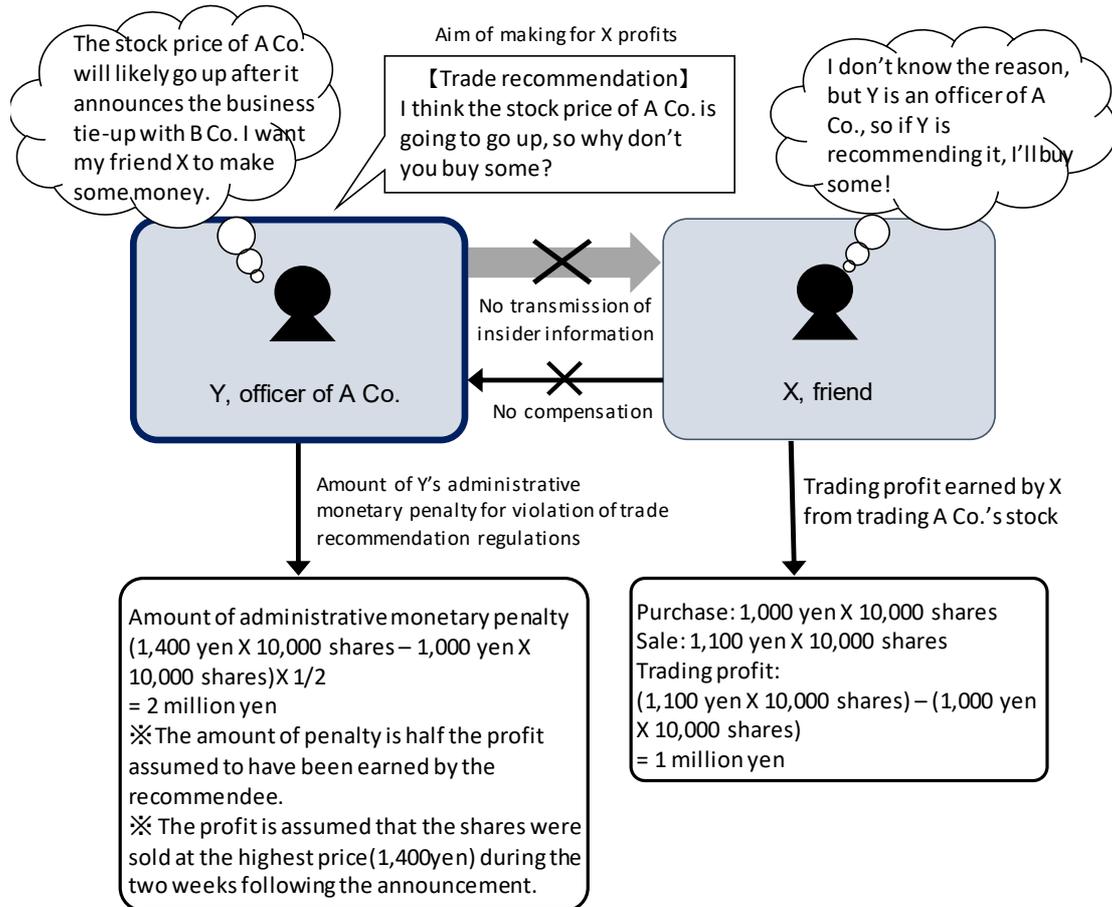
Insider trading regulations which prohibited persons from providing the insider information or making trade recommendations to others were introduced in April 2014. Since then, there have been 16 cases of violations (one of which was violation of both regulations on information provision and trade recommendation). In FY2018, there was 1 case of information provision and 3 cases of trade recommendation.

If an officer of a listed company knows insider information and recommends a trade to others with the aim of making a profit for them, the officer will be in breach of regulations on trade recommendation, even if the officer does not convey the insider information itself. Most listed companies have established rules for preventing insider trading and these prohibit the transmission of insider information, but some companies still do not reflect regulations on trade recommendations in their rules.

A person who makes trade recommendation may do so by thinking, “the transmission of insider information is prohibited, but I still want to make my close friends happy by enabling them to make some money.” However, even if the recommending person doesn't receive a financial reward, he/she would still be subject to an administrative monetary penalty payment order, and the amount of the penalty could exceed the trading profit made by the person receiving the recommendation.

The SESC therefore encourages that listed companies will take steps to prevent trade recommendations by, for example, including relevant provisions in the internal rules and sharing company-wide that trade recommendations, even if they do not involve transmission of insider information, are still subject to insider trading regulations.

Case Study 2: Do you know about regulations on the trade recommendation?  
 - Even if you don't convey insider information, it may still be against the law!



## We are also watching cross-border transactions closely

### <Message to offshore investors>

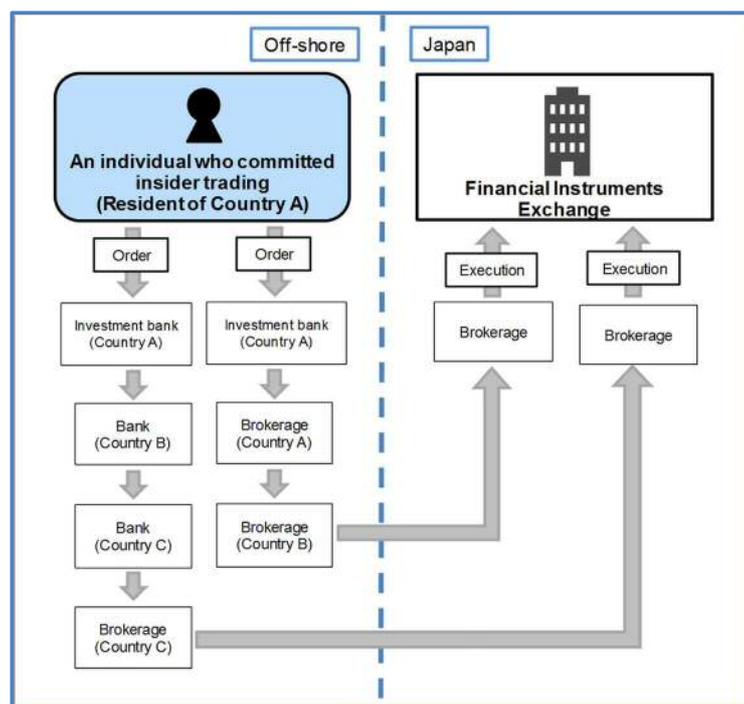
The SESC responds proactively for cases of insider trading using cross-border transactions (transactions by offshore investors involving two or more countries or regions).

Offshore investors' trading share of Japanese equity increased to about 70% of total trading volume in FY2018, twice as much as 26 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 Cross-Border Investigation Office in August 2011 to conduct in-depth investigations of suspected market misconducts by individual investors and companies residing outside Japan.

Cross-Border Investigation Office has investigated numerous cases of suspected market misconducts, including complex transactions where share purchase orders were placed through multiple countries to the exchange in Japan. The SESC analyses and identifies beneficiaries of suspected transactions through continuous collaboration with foreign authorities and makes recommendations for administrative monetary penalties appropriately.

The diagram below illustrates one of the cross-border insider trading cases where 9 brokerage firms in 4 different countries and regions including Japan transmitted and executed transactions. The SESC identified that the transaction was ultimately linked to an individual residing in country A.



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

## 2-3 Investigation into market misconduct

### 1. Purpose of market misconduct

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 payment order, such as insider trading, market manipulation, spread of rumors and use of fraudulent means.

### 2. Overview of cases in FY2018

The SESC promptly and efficiently investigates suspected market misconduct cases through active use of the Administrative Monetary Penalty System. In FY2018, there were 33 cases of market misconduct (23 cases of insider trading, 7 cases of market manipulation, and 3 cases of fraudulent means) in which the SESC made recommendations of administrative monetary penalty payment orders.

#### (1) Insider trading

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In FY2018, there were 23 cases of insider trading for which the SESC made recommendations of administrative monetary penalty payment order (See Fig. 2-3-1).

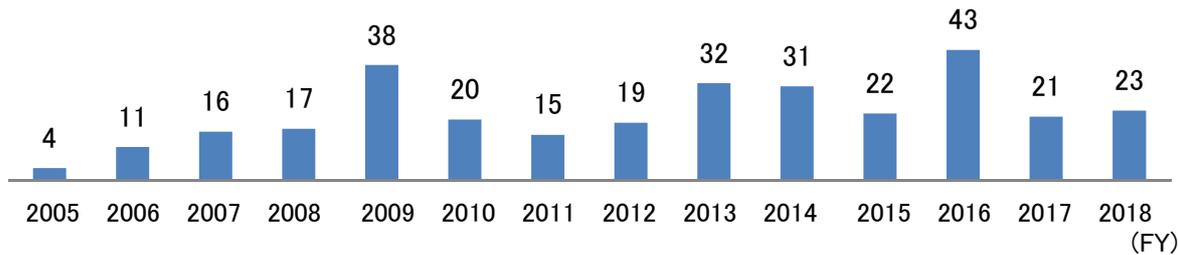
Of the 19 individuals who were issued administrative monetary penalty payment orders for insider trading, the largest number of orders were issued against employees of listed companies (9 individuals, 47 percent of total wrongdoers of insider trading), followed by friends and colleagues (3 individuals, 16 percent) and customers (2 individuals, 11 percent) who unlawfully traded on material facts informed by corporate insiders (See Fig. 2-3-2).

Although there were no cases of insider trading by directors of listed companies, there were 4 cases of insider information being leaked by directors of listed companies (one case was a breach of insider trading regulation which prohibited persons from providing insider information to others). Directors of listed companies must manage information about material facts appropriately and take the initiative to prevent insider trading. Instead, these directors continued to provide information to others without business needs and caused insider trading.

There were 4 cases of violations of rules which prohibited persons from providing insider information or making trade recommendation to others (the rules on information provision and

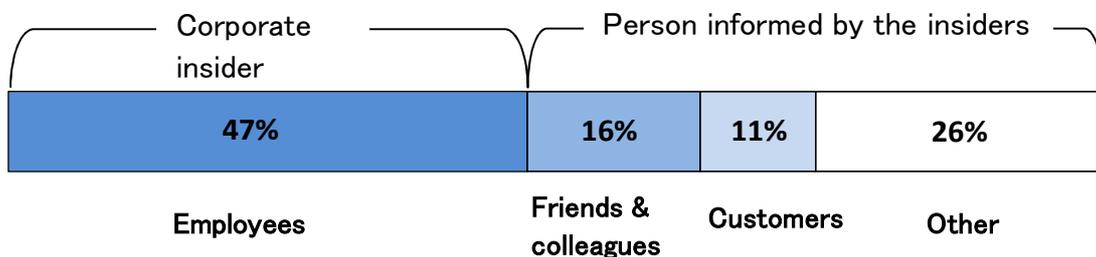
trade recommendation). One of these was a breach of rules on information provision and 3 were breaches of rules on trade recommendation. A recommendation for administrative monetary penalty payment order against insider trading case which violated the rules of trade recommendation was made in FY2018 for the first time since the introduction of rules on information provision and trade recommendation in April 2016.

Fig. 2-3-1: Number of cases of insider trading

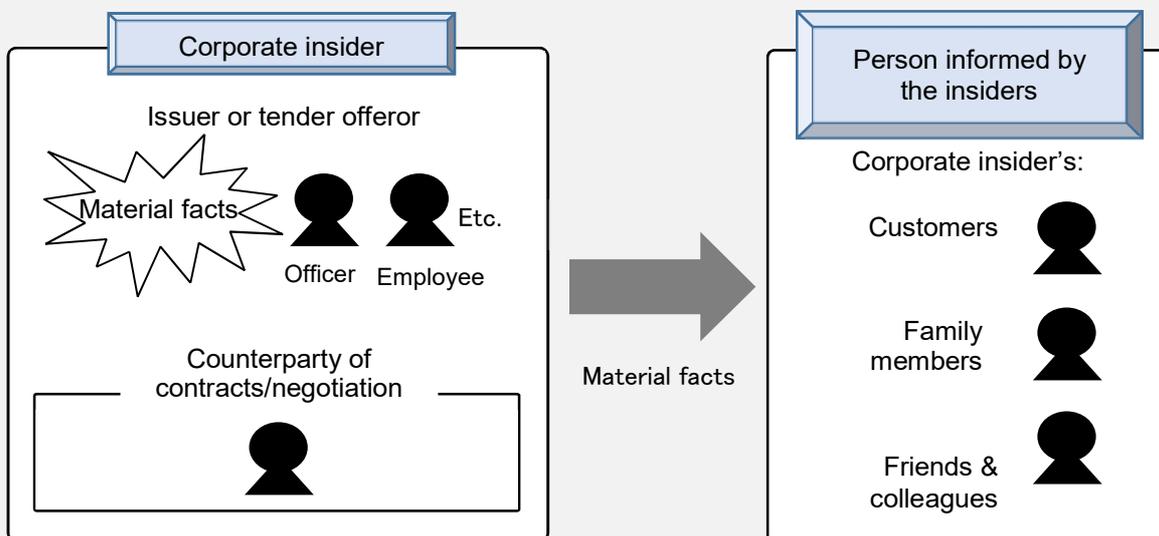


Note: The numbers include cross-border cases.

Fig. 2-3-2: Attributes of wrongdoers of insider trading in FY2018



(Reference) Attributes of wrongdoers

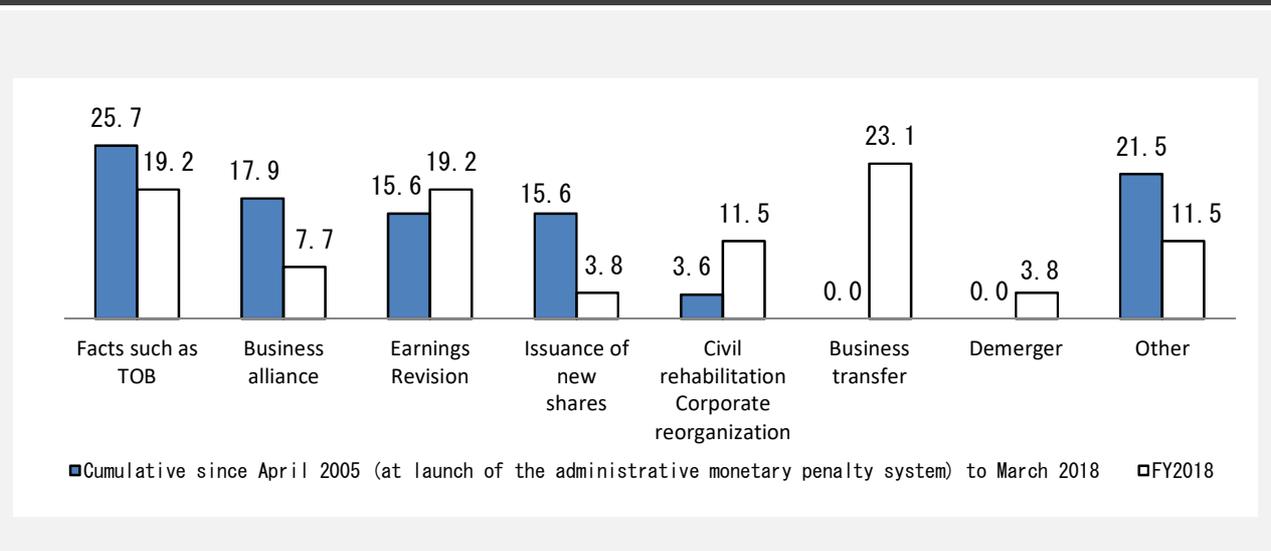


In FY2018, the SESC made a total of 23 recommendations concerning 26 material facts (the number of recommendations and the number of material facts do not match because there were wrongdoers of insider trading on multiple material facts). By types of material facts involved, 6 cases involving information on business transfers (23.1%), 5 on TOBs (19.2%) and 5 on earnings revisions (19.2%), and 3 on civil rehabilitation (11.5%) (See Fig. 2-3-3).

The SESC made recommendations of monetary penalty payment order against cases for the first time concerning business transfers and company demergers. Regarding business transfers, it was a decision made as part of efforts to rehabilitate the business in order to respond to a deterioration in the company's finances as a result of heavy costs stemming from faults in the company's products. As for demergers, it was a decision made for the purpose of strengthening the company's management structure in response to significant changes in the environment surrounding the sector. It is likely that listed companies will continue to employ various methods for corporate reorganization as means of improving profitability amid severe business environments, and similar cases of insider trading are likely to occur in the future.

Furthermore, the decision-making process relating to corporate reorganization normally involves more than just internal discussions, contracts and negotiations with various parties outside the company. As a result, there tends to be a long period between decisions concerning material facts and their public disclosure. Material information therefore needs to be managed very carefully.

Fig. 2-3-3: Breakdown of cases by insider information as a material fact



The SESC's investigation of insider trading revealed many listed companies that had never revised rules for preventing insider trading since they had established such rules, and quite a few listed companies whose rules did not contain any statements about prohibition of trade

recommendations. There were also listed companies where individuals who had become aware of material facts were permitted to buy and sell the company's stock. Even though a system for preventing insider trading had been established, it was not functioning effectively in practice.

Key Case (insider trading):

Overview	Date of recommendation /amount of administrative monetary penalty	Points
<p>9 employees of a TSE First Section listed company came to know material facts in the course of their work (6 employees knew about a business transfer and 3 employees knew about civil rehabilitation) and sold shares before the public disclosure of the material facts</p>	<p>March 1, 2019 Total for 9 employees: 7.73 million yen Penalty per person: 150,000 yen - 1.91 million yen</p>	<ul style="list-style-type: none"> <li>▪ Insider trading by 9 employees of a listed company</li> <li>▪ The 9 employees submitted trade request forms in accordance with internal procedures and obtained permission for their trades</li> <li>▪ Business transfer was recognized as a material fact in insider trading for the first time</li> </ul>

## Key Case (trade recommendation)

Overview	Date of recommendation /amount of administrative monetary penalty	Points
<p>An employee of a TSE First Section listed company came to know material facts (e.g. information about a tender offer) in the course of their work and recommended buying shares to a friend to enable them to make a profit</p>	<p>August 31, 2018 1.94 million yen</p>	<ul style="list-style-type: none"> <li>▪ First case of violation against the trade recommendation only</li> <li>▪ No restrictions on making trade recommendations were included in internal rules, and employees were not made aware of regulations on the trade recommendations during internal training programs</li> </ul>

## (2) Market manipulation

In FY2018, the SESC made recommendations for administrative monetary penalty payment orders for 7 cases of market manipulation, which included 2 cases by the institutional investors.

Trading schemes have become more complex and maneuvered. For example, in order to avoid the detection, wrongdoers executed some spoofing orders instead of cancelling them all. Another trader repeatedly placed buy orders at the basic minimum units of trade in order to boost the price of the stock. In addition, an institutional investor placed spoofing orders of long-term government bond futures in a night session.

The SESC also made a second recommendation of monetary penalty payment order against the case of a market manipulation by wrongdoers who had been subject to an administrative monetary penalty payment order within the past five years (the amount of the penalty was increased by 1.5 times).

## Key Case (market manipulation):

Overview	Date of recommendation/ amount of administrative monetary penalty	Points
An individual investor manipulated the market for two TSE JASDAQ listed stocks through spoofing and repeated purchasing	December 11, 2018 795,000 yen	<ul style="list-style-type: none"> <li>▪ A investor did not delete spoof buy orders after selling them at a profit, but allowed them to be executed to build up inventory</li> <li>▪ The amount of the penalty was increased by 1.5 times in accordance with provisions concerning additional penalties on the grounds that it was the second time the wrongdoer had been subject to a recommendation for administrative monetary penalty payment order</li> </ul>

## Key Case (institutional investors)

Overview	Date of recommendation/ amount of administrative monetary penalty	Points
Offshore financial institution manipulated the market for long-term government bond futures (Osaka Securities Exchange) by spoofing orders on a large scale	March 26, 2019 133.37 million yen	<ul style="list-style-type: none"> <li>▪ First case of manipulation in listed derivatives by an offshore institutional investor</li> <li>▪ The institution spoofed large numbers of both buy and sell orders</li> </ul>

**(3) Fraudulent means**

Fraudulent means refers to fraudulent or unfair strategies and methods to mislead others. In FY2018, the SESC made recommendations for administrative monetary penalty payment orders for 3 cases of fraudulent means.

In all 3 cases, services provided by certain securities companies for a fee or free of charge were used. The services enable the users to check boards which carry the prices and numbers of shares for all orders. The trade methods in all 3 cases were unique<sup>12</sup> in that wrongdoers placed spoof orders in order to create a false demand-and-supply balance and to block orders by third parties who would trade based on the actual demand-and-supply balance. Then selling (or buying) at high prices (or low prices) was achieved by avoiding execution of the spoof orders just before the market close.

This conduct is unfair because it only produces profits for the wrongdoers who know the actual demand-and-supply balance, and blocks orders from other investors who are unaware of the situation. The SESC deemed such a unique trade method of spoofing to be a fraudulent means as specified in Article 158 of the FIEA and made its first recommendation for administrative monetary penalties payment order against the trade method.

**Key Cases (fraud):**

Overview	Date of recommendation/ amount of administrative monetary penalty	Points
An individual investor used market-on-close (MOC) orders (market orders that are submitted to execute as close to the closing price as possible) for 7 TSE	October 5, 2018 730,000 yen	<ul style="list-style-type: none"> <li>▪ The investor effectively blocked orders by other investors through a spoofed sell orders</li> <li>▪ In order to make buy orders outweigh sell orders, the investor bought the shares just before the market close, and at</li> </ul>

<sup>12</sup> For example, a wrongdoer identifies stocks for which other investors have made buy market-on-close (MOC) orders, and then makes sell MOC orders without any intention of executing them in order to make false demand and supply balance and block orders by other investors. The method is contrary to the general spoofing, which is aimed at inducing trading orders from other investors.

First Section and Second Section stocks		<p>around the same time, prevented execution of the spoof orders</p> <ul style="list-style-type: none"> <li>• The investor aimed at selling the purchased shares at high prices</li> </ul>
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### 3. Future challenges

Due to changes in the economic environment in Japan and abroad, share prices are affected by economic activities and judgments on corporate valuation which were not assumed at establishment of the FIEA. For example, certain data falsification, which does not fall under the event of insider trading 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 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.

For market misconduct investigations, it is important to ensure the restoration and preservation of the data of the electronic devices of the investigated entities. 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. To this end, the SESC will work to further improve its digital forensic technology.

To respond to cases of market misconduct, which are becoming increasingly global in nature, the SESC utilizes the IOSCO MMoU<sup>13</sup>, which has been signed by securities regulators around the world, to cooperate with foreign authorities. The SESC will also work to reinforce relationships and trust with overseas regulators through the exchange of a wide range of information and discussions, including through mutual visits. In this way, the SESC will continue to find out more about market misconduct involving cross-border transactions.

Furthermore, as a means of enhancing market discipline, the SESC distributes information after recommendations have been made (by posting it on our website, media briefing and

<sup>13</sup> Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information

through our “Message to the Markets<sup>14</sup>”). The SESC also gives lectures and contributes articles on a variety of topics, as well as publishes a casebook of administrative monetary penalties. Going forward, the SESC continuously endeavors to enhance its external communications by making the information more specific and easier to understand so as to prevent occurrence of future market misconduct.

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<sup>14</sup> In April 2019 the SESC email newsletter was revamped and renamed as “Message to the Markets”  
<https://www.fsa.go.jp/sesc/message/index.htm>

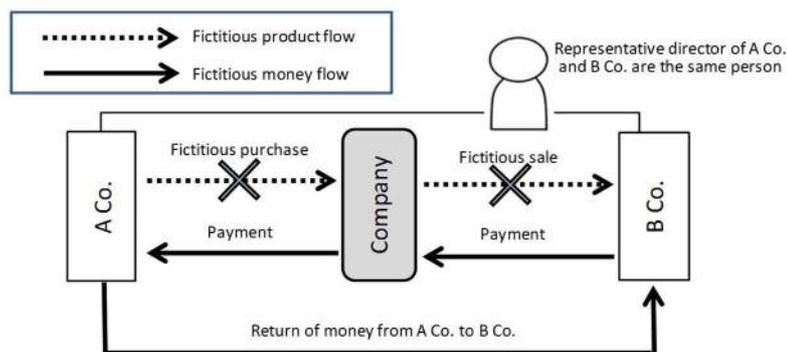
## Before starting a transaction, do you recognize the reality of such transaction?

### <Message to listed companies>

During the disclosure statement inspections in FY2018, the SESC discovered multiple cases of disclosure requirement violations resulting from inappropriate accounting practices. In these cases, listed companies participated in distribution channels involving nonexistent, fictitious trades (fund-circulating transactions) without properly confirming and verifying that the transactions are genuine, which then resulted in the companies booking fictitious sales. Below are the details of one of such cases.

<Summary of violation of disclosure regulation (booking fictitious sales in connection with fictitious trades)>

- Suffering from poor operating performances, a company tried to improve its profits through participating in a new business of distributing silicon carbide. It booked sales based on the involvement in transactions for such materials.
- However, the SESC's inspections revealed that the transactions were fictitious and the company had overstated its sales by booking fictitious sales. The scheme is illustrated below.



<Background to participation in distribution channels involving fictitious transactions>

- A director and sales manager was dispatched from company C, which is the company's top shareholder, in order to improve the company's management. This person had offered to the representative director of both A and B that the company be included in distribution channels for silicon carbide, which led to the commencement of the fictitious transactions.
- When joining the distribution channels for the fictitious transactions, the company did not investigate whether the transactions actually existed or the rationality for participating

in the distribution channels. The company also did not properly confirm and verify the credit worthiness of the business partners on the grounds that the deal had been suggested by the aforementioned director and sales manager and that the transactions involved company B, which was a business partner of company C, the company's top shareholder.

- Furthermore, in the distribution channels, the silicon carbide was supposed to be delivered directly from company A to B, but the company failed to confirm the location of the product inventory or examine documentary evidence relating to the transactions. Even after the transactions had begun, it did not properly confirm whether the transactions were genuine.

In the background to the above case were the facts that the deal had been suggested by an employee who had been dispatched from the top shareholder company and that the company was in search of transactions that would provide a new source of revenues as it sought to improve its operations amid sluggish performance. Nevertheless, the SESC encourages that the companies would establish and properly implement internal management structures by, for example, establishing systems which ensure the authenticity of every transaction regardless of its background.

## 2-4 Inspection & information gathering on violations of disclosure regulations

### 1. Purpose of disclosure statements inspection

The FIEA's disclosure regulations are aimed at protecting investors by providing them with appropriate 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, which provide details on their business profile and financial condition, among others. These documents are available for public and provide necessary 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 they lack information which should have been included, it may cost unexpected losses to investors.

To avoid such situation, the SESC conducts inspections of disclosure statements, in which the SESC requires issuers to make corrections to submitted disclosure documents or makes recommendations for administrative monetary penalty payment order against those who violated disclosure regulations by, for example, including serious misinformation in the documents. The SESC is also engaged in various initiatives to prevent occurrences and recurrences of violations of disclosure regulation.

### 2. Disclosure statements inspection and trends of violations in FY2018

In FY2018, the SESC conducted 38 cases of disclosure statements inspection, including those continued from FY2017. Of these, 20 cases were completed. Among the completed 20 cases, the SESC recommended administrative monetary penalty payment orders in 10 cases where material misstatements and other violations were found in disclosure documents. In case it was deemed necessary for the issuers to amend the contents of disclosure documents, the SESC urged them to voluntarily submit correction reports, even if the SESC did not recommend administrative monetary penalty payment orders.

Furthermore, in cases where violations of disclosure regulations were identified, the SESC discussed the background and causes of such violations with the management of the listed company, even if a recommendation for administrative monetary penalty payment order was not made. By sharing the authority's perceptions of the issues in this way, the SESC encouraged the

## 2-4 Inspection &amp; information gathering on violations of disclosure regulations

issuers to establish and improve internal systems for proper information disclosure, in order to prevent recurrence of the issues. Concerning the listed companies that are not very proactive in establishing and improving internal systems for proper information disclosure, the SESC coordinated with relevant organizations (financial instruments exchanges, audit firms and others) and shared information on them as appropriate and in a timely manner, with the aim of preventing recurrences of the similar violations of disclosure regulations.

In addition to these activities, the SESC also conducts ongoing monitoring of large listed companies, as well as in-depth examination and analysis which take into account changes in their business environment, in order to swiftly identify listed companies suspected of violations of disclosure regulations. This approach reflects the occurrence of violations of disclosure regulations at some of Japan's most prominent global companies and the appearance of inappropriate accounting practices incentivized by the impact of changes in the macro-economic environment on corporate earnings.

## (1) Cases which administrative monetary penalty was recommended

## Key Cases:

	Description	Date of recommendation/ amount of administrative monetary penalty	Backgrounds
1	The company did not properly book impairment losses on goodwill that occurred when it turned an affiliate into a consolidated subsidiary. It also overstated the sales and inventory of a renewable energy business operated by the consolidated subsidiary.	December 18, 2018 131.7 million yen	<ul style="list-style-type: none"> <li>▪ With its main business continuously performing poorly, the company hoped to make the business of the affiliate a new source of profits, and turned the affiliate into a consolidated subsidiary. However, the management structure established for overseeing the consolidated subsidiary was inadequate.</li> <li>▪ Because the company did not appropriately manage and</li> </ul>

## 2-4 Inspection &amp; information gathering on violations of disclosure regulations

			<p>monitor the business of the consolidated subsidiary, it did not consider booking impairment losses on goodwill in connection with the transaction, even though the consolidated subsidiary was continuously suffering operating losses.</p>
2	<p>After the company had submitted a securities registration statement, there was a change in the “expected recipients of allotment” stated in the securities registration statement prior to the effective date of the registration statement. Even though this constituted a “change in important matters,” the company offered stock acquisition right certificates without submitting an amendment statement.</p>	<p>December 18, 2018</p> <p>13.91 million yen</p>	<p>The company has significant defects in its internal controls. For example, the former representative director of the company, who led offering stock acquisition right certificates had excessive influence on the policy decisions of the company, while directors and corporate auditors lacked the awareness of the importance of discussions at the Board meetings.</p> <p>(Similar report has been made by an investigative report compiled by the company’s internal investigation committee.)</p>
3	<p>The company overstated sales by booking fictitious sales based on fictitious trades performed by a consolidated subsidiary.</p>	<p>January 22, 2019</p> <p>12 million yen</p>	<ul style="list-style-type: none"> <li>Internal controls within the consolidated subsidiary did not function effectively. The management of the consolidated subsidiary overemphasized the importance of sales, and were engaged in inappropriate</li> </ul>

## 2-4 Inspection &amp; information gathering on violations of disclosure regulations

			<p>accounting practices involving these fictitious transactions</p> <ul style="list-style-type: none"> <li>▪ Audits of the consolidated subsidiary by the company's corporate auditors and internal audits were not conducted properly.</li> </ul>
4	The company overstated sales from its video planning/production business. Furthermore, it did not properly book impairment losses on contributions that it made to a video production committee.	<p>February 13, 2019</p> <p>135.4 million yen</p>	<ul style="list-style-type: none"> <li>▪ The first priority was the achievement of the sales target, and some of the management members took the initiative in accounting excessive sales.</li> <li>▪ With regard to its video planning operations, the company had not established objective and verifiable standards for booking sales.</li> </ul>

9 of the 10 cases for which recommendations for administrative monetary penalty payment orders were made in FY2018 relate to excessive sales. In 3 cases, a listed company participated in distribution channels involving nonexistent and fictitious trades without properly confirming and verifying that the trades actually existed. Sales (which were fictitious) were booked in connection with the fictitious trades. These inappropriate accounting practices resulted in material misstatements in consolidated financial statements. (See Column: “Before starting a transaction, do you recognize the reality of such transaction?”).

The SESC also examines and inspects the appropriateness not only of financial information but also of non-financial information contained in securities reports. In FY2018, it made a recommendation for administrative monetary penalty payment order in one case of violation of disclosure regulations relating to non-financial information (Case 2).

The following are examples of backgrounds and causes that led to material misstatements and other violations of disclosure regulations that became subject to the recommendations for administrative monetary penalty payment order in FY2018:

## 2-4 Inspection &amp; information gathering on violations of disclosure regulations

- The parent company's internal controls did not function effectively with respect to consolidated subsidiaries, making it impossible to discover and prevent inappropriate accounting practices at subsidiaries (Cases 1 and 3)
- An excessive focus on achieving sales or profit targets made internal controls not effective (Case 4)

As stated earlier, with regard to the backgrounds and causes of violations of disclosure regulations, the SESC, in the course of conducting disclosure statements inspections, has discussions and shares its perceptions of issues with the management of listed companies, thereby encouraging them to establish and improve internal systems for proper information disclosure in order to prevent recurrences of violations.

(2) Cases in which the SESC conducted fact finding about the functioning of internal controls and followed up on the improvements

Overview	Backgrounds
<p>Material deficiencies in internal controls that should be disclosed were duly described in the company's internal control report. These included issues that had been pointed out during internal and external audits, but had not been properly addressed.</p>	<ul style="list-style-type: none"> <li>▪ The accounting department had not secured the personnel it needed, and training/education for accounting staff was inadequate.</li> <li>▪ Internal auditors with appropriate abilities had not been assigned.</li> </ul>

The SESC conducts disclosure statements inspections of listed companies where it is deemed that the functioning of internal controls needs to be improved. If a deficiency in internal controls is identified, the SESC discuss improvement measures with the management in order to prevent occurrence of violations of disclosure regulations.

In FY2018, the SESC conducted disclosure statements inspections of listed companies that had stated in their internal control reports that there were "material deficiencies that should be disclosed." In addition to conducting fact finding about the functioning of internal controls and following up on the situation of improvement, it also investigated whether the deficiencies had led to any contravention with accounting standards.

### (3) Disclosure statements inspection of persons who may have committed specified acts of involvement

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The SESC also proactively conducts inspections regarding the Specified Acts of Involvement<sup>13</sup>.

In FY2018, as part of disclosure statements inspection in a case of fictitious sales by fictitious transactions that resulted in the recommendation for administrative monetary penalty payment order, the SESC inspected another company which may have been involved in the fictitious transactions and may have committed the Specified Act of Involvement. The SESC will continue to watch for similar cases closely.

## 3. Future challenges

### (1) Upgrading analysis capabilities

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As part of our efforts to gather and analyze information from macro perspectives the SESC will be conducting continuous monitoring of large companies by market capitalization which are considered to have relatively large market impacts. The SESC will continue to gather and analyze information on listed companies with a focus on the risk of wrongdoings. The SESC will also continue to carry out in-depth examination and analysis of changes in the companies' business environments, and continue to gather and analyze information that captures actual state of business, such as value chains and business customs.

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

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#### (i) Sharing the authority's perception with management

To prevent the recurrence of violations, the SESC will hold discussions on the backgrounds and causes of violations with the management of listed companies which violated disclosure regulations and share the perception of existing issues, thereby urging the management to establish an appropriate information disclosure system. The SESC will also work with relevant organizations to discuss effective methods of encouraging listed companies that are not being proactive in developing effective internal system for information disclosure to make improvements.

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<sup>13</sup> Refers to acts that facilitate or instigate the submission of disclosure documents containing material false statements.

(ii) Proactive communication with stakeholders

As part of measures to prevent violations of disclosure regulations, when providing information on cases on which recommendations for monetary penalty payment orders were made (on the SESC's website, at media briefings, etc.), the SESC has always delivered as clear explanations as possible. The SESC also promotes listed companies' internal discussions towards appropriate information disclosure and dialogue between listed companies and their certified public accountants/audit firms by annually publishing a case book presenting actual cases of violations identified through the inspections. Through proactive communication with stakeholders, the SESC will continue its efforts to prevent the occurrence and recurrence of violations of disclosure regulations.

## 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 would damage the integrity of financial instruments transactions and protection of investors, the SESC was given the authority to investigate criminal cases since its establishment in 1992. In addition, some of the clauses defined under the Act on the Prevention of Transfer of Criminal Proceeds, which regulates cross-border money laundering, are now in the scope of the criminal investigation by the SESC.

### 2. Overview of criminal charges in FY2018

Given increasingly global, complex and sophisticated trading activities in the financial markets, the SESC flexibly investigates criminal cases in both primary and secondary markets. In FY2018, the SESC filed criminal charges for 8 cases, including 5 cases of suspected insider trading and 3 cases of submission of false securities reports. These cases included a case in which an employee of a securities company which was serving as a FA (financial advisor) to a corporation transmitted information on its planned tender offer, and the recipient of the information conducted insider trading (filed on December 18, 2018). Another is a case in which a corporation and 2 of its officers submitted a securities report containing false statements concerning executive compensation (filed on December 10, 2018 and January 10, 2019).

Cases	Date of filing of criminal charges	Filed with
Insider trading of the shares of Sumida Corporation	June 18, 2018	Public Prosecutor of the Tokyo District Prosecutors Office
Insider trading of the shares of Asatsu-DK Inc.	October 30, 2018	
Insider trading of the shares of LC Holdings Inc. (1)	November 13, 2018	

Insider trading of the shares of LC Holdings Inc. (2)		
Submission of false securities report for Nissan Motor Co., Ltd. (1)	December 10, 2018	
Insider trading of the shares of Dalton Corporation	December 18, 2018	Public Prosecutor of the Osaka District Public Prosecutors Office
Submission of false securities report for Nissan Motor Co., Ltd. (2)	January 10, 2019	Public Prosecutor of the Tokyo District
Submission of false securities report for Sorghum Japan Holdings Corp.	January 20, 2019	Public Prosecutors Office

Among the above cases, details for the case of insider trading of shares of Dalton Corporation, the case of submission of false securities report for Nissan Motor Co., Ltd., and the case of submission of false securities report for Sorghum Japan Holdings Corp. are provided in the following section.

### 3. Notable charges filed in FY2018

#### (1) Charges in the case of insider trading of shares in Dalton Corporation

The SESC filed charges for FIEA violation (insider trading, information transmission) against two suspects on December 18, 2018 with the Osaka District Public Prosecutors Office.

Case overview:

Suspect A was an employee of SMBC Nikko Securities Inc. (“SMBC Nikko”). Other employees of the SMBC knew that the facts that a decision-making body of Itoki Corporation (“Itoki”) had decided to conduct a tender offer for Dalton Corporation (“Dalton”) shares which were listed on JADAQ market operated by the Tokyo Stock Exchange (TSE). They knew the facts in the course of the conclusion of a financial advisory contract between SMBC Nikko and Itoki. In late July 2016 Suspect A became aware the facts through the course of his business. Subsequently, the following purchases were made:

1. Suspect B was informed by Suspect A of the facts of the tender offer (mentioned above), despite of no exception clause applicable under the FIEA, purchased a total of 296,000 Dalton shares for a total amount of approximately 53 million yen in his own name on the TSE via a securities company between around late July and around early August 2016, which was prior to the public announcement of the tender offer.

2. Suspect A, with the aim of enabling gaining of profits through the advance purchase of Dalton shares, informed Suspect B of the facts concerning the prospects of the tender offer in late July 2016, and as result, Suspect B purchased Dalton shares as described in 1.

Note: The material facts in the case of this tender offer was that Itoki, which was the tender offeror, had decided to make a tender offer for the shares of Dalton, which was its subsidiary. Itoki publicly announced the fact in a notice entitled “Notice Concerning Commencement of Tender Offer for Ordinary Shares of the Subsidiary Dalton Corporation (security code: 7432)” at 4:00 p.m. on August 3, 2016.

With regard to this case, it should be noted that Suspect A, who was an employee of a securities company which was serving as a financial advisor for Itoki, became aware, through the course of his business, of the prospects of a tender offer that would be certain to push up the stock price of Dalton. Suspect A then transmitted the information to Suspect B. Then Suspect B, who purchased a large quantity of Dalton shares before the facts were publicly announced and earned significant profits. The SESC therefore views this case as extremely malicious.

## (2) Charges in the case of submission of false securities report for Nissan Motor Co., Ltd.

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The SESC filed charges for FIEA violation (submission of false securities report) against one corporate and two individual suspects on December 10, 2018 and January 10, 2019 with the Tokyo District Public Prosecutors Office.

### Case overview:

Suspect Nissan Motor Co., Ltd. have its shares listed on the first section of TSE. Suspect A was a representative director and chairman and Suspect B was a representative director of the corporation. Both individuals conspired to conceal part of the compensation, bonuses, and other forms of remuneration that Suspect A received as a director from the corporation and its major consolidated subsidiaries in the consolidated accounting year. They submitted

a securities report containing false information on the “total amount of consolidated compensation for each director” section, which is part of the “situation with corporate governance” section.

The situation with corporate governance of listed companies is extremely important for investors when making investment decisions. More specific information on executive compensation is critical for assessing the company’s governance and making investment decisions, because it provides such viewpoints as whether the compensation is commensurate with the performance of the company or individual officers, whether it is appropriate as an incentive to individual officers, and whether there is any distortion in the company’s governance. Therefore, such information must be properly disclosed and false statements are likely to substantially impact investors’ investment decisions. This was the first case of charges being filed for submission of a securities report containing false amounts of executive compensation.

(3) Charges in the case of submission of false securities report for Sorghum Japan Holdings Corp.

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The SESC filed charges for FIEA violation (submission of false securities report) against a corporate and 3 individual suspects on March 20, 2018 with the Tokyo District Public Prosecutors Office.

Case overview:

Suspect Sorghum Japan Holdings Corp. (“SJH”), which was listed on the JASDAQ market (delisted on September 3, 2018), was a company whose purpose was to control and administer, through the acquisition and holding of shares or equity stakes, the business activities of other companies operating businesses of planning, development, sales or import/export of products and services relating to plant seeds and plant-based manufactured goods. Suspect A was the person who had a substantial power over SJH, and Suspect B was a representative director of SJH, and Suspect C was a director and senior executive of SJH.

With regard to the operations and assets of the company, the Suspects conspired to submit a securities report (April 1, 2016–March 31, 2017) that contained false statements concerning important matters. Specifically, the report contained a consolidated statement of cash flows stating that cash flow from operating activities was positive and amounted to approximately 133.741 million yen, even though the true figure was negative and amounted

to approximately 966.258 million yen, by falsely presenting borrowings of 1.1 billion yen as proceeds from overseas sales of super-sorghum seeds.

Charges were filed in the case because it was deemed that the company had evaded being delisted by inflating its cash flow from operating activities by an amount of 1.1 billion yen by falsely presenting a loan as proceeds from overseas sales of seeds, and that this constituted a serious false statement that would substantially impact investors' investment decision. This was the first case of charges being filed for submission of a securities report containing a false statement of cash flows.

#### 4. Issues regarding investigation of criminal cases

The SESC will continue to take rigorous actions against severe and malicious market misconduct by appropriately exercising its authority for criminal investigation and filing criminal charges in cooperation with criminal prosecutors and other relevant authorities. The SESC will continuously 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 on various market misconducts for seamless market monitoring.

It is also essential that the SESC flexibly responds to changes in the environment surrounding securities trading. For example, the recent developments in information technology has made it easier for anyone to use communication devices to access information and has led to new types of communication tools such as SNS. Such changes in the environments were not anticipated 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 continuously contribute 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 including foreign authorities.

## 2-6 Enhancing infrastructure for surveillance (IT and HR)

### 1. Measures against structural changes in markets

To understand financial technology trends 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. Furthermore, in response to recent market trends such as increasing speed and complexity of financial transactions in connection with advances in IT and the development of new financial instruments and transaction schemes, in FY2018, the SESC examined technological challenges and took steps toward the deployment of a new, advanced system with the aim of making market surveillance more effective and efficient.

### 2. Challenges for the future use of information technology

#### (1) Consideration of introducing new market surveillance system

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In FY2018, with the aim of utilizing IT to make the market surveillance more effective and efficient, the SESC studied challenges ahead of the establishment of a better supervisory technology system for market surveillance (SupTech), and conducted verification testing for potential use of AI in the system with the cooperation of external businesses. Going forward, taking into account the results of the studies and verification testing, the SEC will advance discussions toward the deployment of a system that features the following technologies:

- Technologies that detect and analyze market misconducts from among a large volume of order and transactions data
- Technologies that detect a sign of fraud in the markets from big data, including macroeconomic trends and corporate financial information
- Technologies that gather data necessary for market surveillance smoothly and at low cost from market participants such as financial institutions

#### (2) Working with private sector entities to Build a RegTech Ecosystem

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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 the fairness and transparency of the financial markets as a whole by facilitating mutual collaboration and discussion on IT between financial institutions and regulatory authorities. For example, the SESC will exchange opinions with financial institutions on improving the efficiency and effectiveness of IT investment for the entire financial industry and discuss technologies that facilitate smooth exchange of data at low cost with financial institutions.

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

The IT environment surrounding the SESC has been becoming more and more complex, diversified, and sophisticated and the data size to be processed has increasingly enlarged. In the past few years, electronic devices (smartphones, tablet devices, etc.) have become more varied, security and other functions have become more sophisticated, and subjects from which the SESC obtains data have become diversified given the growing use of new IT services (cloud services, etc.).

In order to respond to such changes in the environment surrounding market surveillance, the SESC aims to enhance its IT environment for protecting, recovering, analyzing and storing electronic data, and further improve its digital forensics techniques used to properly deal with data in increasingly diversified and sophisticated electronic devices.

In FY2018, the SESC introduced equipment for the protection of electronic data in smartphones and tablet devices, and in accordance with the Medium-term IT Enhancement Policy (revised in FY2018), the SESC improved the environment for the preservation of electronic data and partially upgraded networks for the digital forensics environment. The SESC will continue to enhance its IT environment as necessary, in accordance with the Medium-term IT Enhancement Policy.

## 3. Staff training

### (1) HR development through OJT and other programs

To develop human resources (HR) with expertise and a broad perspective on market surveillance, the SESC provides on-the-job training (OJT) and various other training programs for its staff to learn about the methodologies for conducting inspection and investigation.

In FY2018, with the aim of developing IT personnel who can contribute to inspection and investigation, the SESC continued to run the Information and Communication Technology (ICT) Training Program, which was launched in FY2017 to enhance the IT expertise of its staff. The SESC also conducted training programs of communication skills for managerial staff necessary to support the development of their team. Further, the SESC took measures to improve junior staff' expertise, including a career path seminar where experienced staff were invited to give lectures. In addition, the SESC sent staff members to foreign authorities as a secondee and seminars organized by foreign authorities or international organizations to learn monitoring, investigation, and inspection knowledge and techniques, and enhance the capability to handle international cases (improvement of skills to analyze and investigate market misconduct using cross-border transactions, etc.) (See Section 2-8-3-(2)).

## (2) Promote HR with expertise

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Based on the policy to actively recruit people with expertise to adapt to changes in the surrounding environment, the SESC has hired professionals from private sectors since 2000, including individuals with expertise and experience in the securities business, lawyers, certified public accountants to reinforce skills of inspection and investigation of the SESC. As of the end of March 2019, a total of 113 professionals from private sectors are in the office (25 newly joined in FY2018).



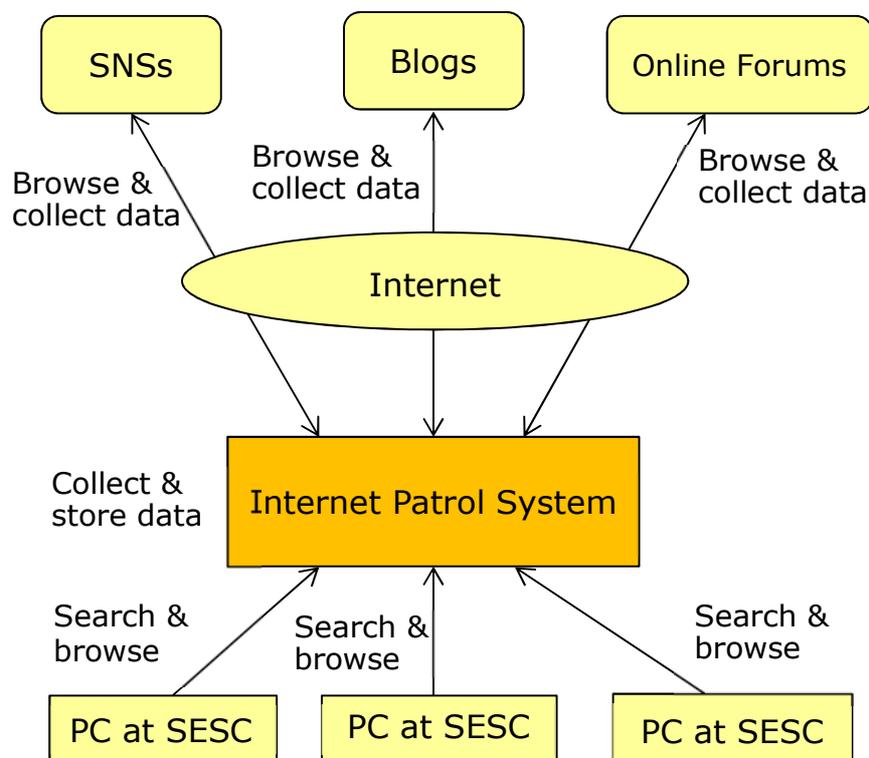
## Social media is under our market surveillance

### <Message to all market participants>

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

Among such information, there are false information intended to influence stock prices (so-called “spreading of rumors”), and information indicating market manipulation such as “there is an investor boosting the price of stock A!” The SESC monitors those information on the internet daily.

Information on the internet can be updated and deleted easily. To avoid missing material information on market misconduct, the SESC utilizes the “Internet Patrol System,” which can retrieve and store data from specific websites (including SNSs, 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 administrative action is recommended or criminal charges are filed as a result of inspection or investigation. In doing so, the SESC actively responds to requests from media organizations, such as newspapers, magazines and TV stations, to explain in the interviews or in writings. To promote dissemination of such information in the form of articles or opinions based on the implications and analysis of such cases and not only factual information, the SESC will continue to exchange opinions and have a dialogue with media insiders.

To increase market participants' understanding of the activities of the SESC, it also posts up-to-date information on its activities on its website, including summaries of cases in which administrative action is recommended or criminal charges are filed as well as 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 subscribers and publishes "Monthly SESC E-mail Newsletter," summarizing the SESC's activities and perceptions in a simple, easy-to-understand format. To ensure that the details and issues 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. Further, since March 2019 the SESC began switching from distributing such information via the SESC E-mail Information Service to social media (SESC twitter account) in order to reach out of a wider range of people.

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

#### (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 throughout the country due to prevalence of the internet, it is necessary that the SESC enhances its presence across Japan.

Thus, the SESC started holding its Securities and Exchange Surveillance Meeting at Local Finance Bureaus in FY2015. In FY2018, the SESC endeavored to communicate its views, enhance the SESC's presence and strengthen cooperation with the Local Financial Bureaus (April 13, 2018 at Fukuoka Local Finance Branch Bureau).

In conjunction with the meeting, the SESC exchanged opinions with regional market participants to deepen their understanding of the SESC's activities and perceptions, while working to increase the SESC's visibility in each region by providing explanations on the purpose of the meeting and an overview of the SESC's operations to local news media.

Through such efforts, the SESC aims toward working to implement rigorous and appropriate market monitoring for the fairness and transparency of markets and investor protection, while strengthening cooperation with the Local Finance Bureaus and regional market participants.

## 2. Cooperation with relevant authorities

### (1) Cooperation with self-regulatory organizations

Self-regulatory organizations (Financial Instruments Firms Associations, Financial Instruments Exchanges, and Japan Exchange Regulation, hereinafter SROs) are engaged in day-to-day monitoring of markets. Their tasks include examination of market transactions, listing management and monitoring the appropriateness of member's operations. 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 emerging issues facing securities markets and to share mutual issues of interest. In FY2018, the SESC continued to strengthen the collaboration and shared information and perceptions in a timely manner through active discussions on challenges and issues regarding market monitoring.

The SESC believes these efforts will further promote shares of views between the SESC and SROs and enhance the self-disciplinary function of markets. The SESC will continue its active exchange of information and communicate its perceptions to achieve closer collaboration.

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

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In cases where the SESC, in the course of market misconduct inspection, identifies unregistered financial instruments business operators selling fraudulent financial instruments or activities that may be associated with anti-social forces, the SESC cooperates with police authorities by sharing information and other measures. In criminal investigations, the SESC works in cooperation with prosecutors that are the filing authorities for criminal charges on a daily basis, which is an example of how the SESC endeavors to strengthen relationships with relevant authorities.

The SESC expands and deepens cooperation with these authorities through daily exchange of information and meetings, sharing know-how related to investigations, emerging issues, and information from wider perspectives. Since FY2016, the SESC had a meeting to exchange views with the Consumer Affairs Agency, and in FY2018, the SESC and the Consumer Affairs Agency organizations continued to share the status of their activities with each other and had discussions on the effective form of cooperation.

In addition, the SESC exchanges information 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 participants, the SESC also has dialogue and shares views with market participants 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 make a policy proposal to the Prime Minister, the FSA Commissioner or the Minister of Finance in order to facilitate appropriate development of rules that reflect the status of markets, if it is considered necessary as a result of its inspections or investigations.

The above provision is intended to incorporate the SESC's views regarding regulations and self-regulatory rules 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 and other organizations formulate policy measures.

Specifically, when relevant laws, regulations or self-regulatory rules can be improved in terms of the given status of trading activities, the SESC clarifies such issues and from the perspectives of ensuring fair trading, investor protection or the public interest, present issues to be discussed on such as desired regulations and self-regulatory rules and requests revisions to existing rules and regulations.

In FY2018, the SESC made two such proposals, one concerning more information provision of borrowers for investors in the funds investing in loan business (December 7, 2018) and one concerning the establishment of procedures for gathering and analyzing electromagnetic evidence for criminal investigations (February 26, 2019). The SESC has made a total of 26 such proposals since its establishment in 1992.

The SESC will continue to make active use of the authority to ensure that measures deemed necessary as a result of inspections and investigations based on the FIEA are actively put forward as proposals.

## 2-8 Contributing to global market surveillance

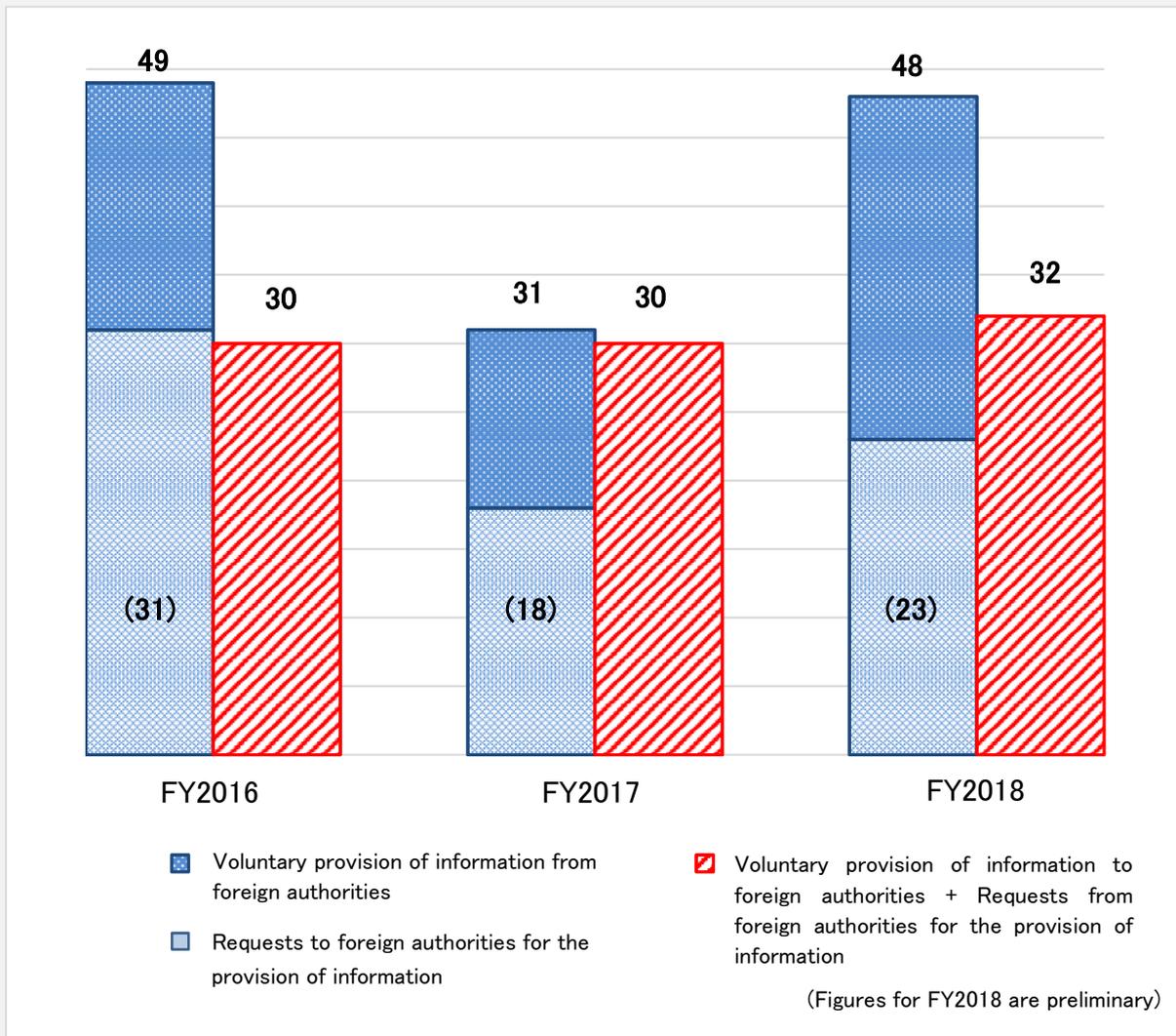
### 1. Overview of global market monitoring

The environment surrounding global markets is increasingly uncertain as the future of the global economy is unpredictable. Furthermore, financial markets in Japan are now under the great influence of global macroeconomic trends and specific events, as Japanese businesses have been actively 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 foreign authorities. 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 published in January 2017.

The SESC has exchanged various information with foreign authorities based on the IOSCO’s Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information (MMoU), and has been enforcing securities laws and regulations against violations involving cross-border transactions.

Fig. 2-8-1 Information exchange with foreign authorities through IOSCO MMoU



The SESC aims to maintain smooth cooperation with foreign authorities by developing mutual trust and reinforcing exchanges of information and collaboration in exercising investigation, inspection and law enforcement authority. The SESC is also taking advantage of relevant information on foreign law enforcement cases and legal systems, which are gained through the cooperation, in its market surveillance.

Further, as issues related to international cooperation are identified through the surveillance activities, the SESC proactively raises such issues and shares information at bilateral meetings as well as multilateral meetings such as those of the IOSCO. In this way, the SESC endeavors to contribute to market surveillance on a global level.

## 2. Activities at IOSCO

IOSCO is an international organization that aims to coordinate securities regulations across jurisdictions and promote cooperation between securities regulators. It is comprised of 219 member organizations of various countries and regions, including 128 ordinary, 27 associate and 64 affiliate members (all figures as of October 2018). 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. To conduct appropriate 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 foreign authorities by exchanging information and views. SESC Commissioners regularly participate in the conference for this reason. In FY2018, the Annual Conference was held in Budapest (Hungary) in May and SESC Commissioner Mami Indo participated. Taking advantage of this valuable opportunity where various regulators gathered from all over the world, bilateral meetings to exchange views are held. 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 foreign authorities in the region.

IOSCO also has the Board consisting of regulators from various countries and region, where key regulatory issues in the international markets are discussed and practical solutions are proposed. Under the IOSCO Board, there are policy committees discussing specific policy issues. In FY2018, the SESC's representatives participated in the Committee 4 (C4) and the Committee on Emerging Risk (CER) among them.

In C4, members discussed 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 exchanged views on initiatives by national regulators in response to advances in information technology, new risks confronting securities and capital markets, among others.

The SESC's representatives also participate in the Screening Group, which reviews applications submitted by regulators to become signatories to the MMoU or the enhanced MMoU

(EMMoU). In FY2018, the Chile CMF<sup>14</sup> and three other regulators signed the MMoU, while the UK FCA<sup>15</sup>, Singapore MAS<sup>16</sup>, and eight other regulators signed the EMMoU.

### 3 Cooperation with foreign authorities

#### (1) Exchanging views with foreign authorities

The SESC actively exchanges views with foreign authorities and with financial institutions that have global operations to recognize international financial/capital market trends and overseas securities regulators' initiatives to ensure the market integrity, and to promote understanding of the SESC's activities. Regarding the activities in FY2018, in November 2018, Commissioner Mami Indo visited China CSRC<sup>17</sup>, where both authorities confirmed that they would further strengthen their relationship. At the working level, the SESC's representatives participated in the Asia-Pacific Regulators Meeting on Market Surveillance in Singapore in September 2018, where regulators from Asia's market surveillance authorities including the Singapore MAS, Hong Kong SFC<sup>18</sup>, and Australia ASIC<sup>19</sup> discussed various practical issues. Furthermore, the SESC exchanged views on various occasions, such as at IOSCO meetings, with overseas securities regulators from the US, Europe and Asia, as well as with globally active financial institutions and international industry organizations, at both executive and working levels. In this way, the SESC remained active in contributing to global market surveillance through the sharing of issues and challenges regarding international cooperation.

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<sup>14</sup> Comisión para el Mercado Financiero (Financial Market Commission)

<sup>15</sup> Financial Conduct Authority

<sup>16</sup> Monetary Authority of Singapore

<sup>17</sup> China Securities Regulatory Commission

<sup>18</sup> Securities and Futures Commission

<sup>19</sup> Australian Securities and Investments Commission

## (2) Sending staff to foreign authorities and participating in short-time training programs

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The SESC has sent its staff as a secondee to the US SEC,<sup>20</sup> US CFTC,<sup>21</sup> UK FCA, Hong Kong SFC, Thailand SEC,<sup>22</sup> Malaysia SC,<sup>23</sup> and Singapore MAS to have the staff learn about and analyze the surveillance, investigation and inspection methodologies of foreign authorities, as well as to share Japanese methods and knowledge. The SESC has also sent staff to short-time training programs hosted by IOSCO or foreign authorities.

Conversely, the SESC regularly offers training programs on Japan's securities market surveillance and investigation of market misconduct for securities regulators for staff of financial regulatory authorities of emerging economies, who are invited to the Global Financial Partnership Center (GLOPAC) set up within the FSA or training programs run by the Japan International Cooperation Agency (JICA). The SESC also provides training to specific securities regulators in response to the request. For example, in June 2018, the SESC held a seminar on the investigation of market misconduct to staff from the Vietnam SSC<sup>24</sup> who were visiting the FSA.

To reinforce the global market surveillance regime, the SESC will strengthen networking with foreign authorities and endeavor to achieve sharing of concerns through the secondment of the SESC's staff, exchanges of views, and visits by senior member of the SESC.

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<sup>20</sup> U.S. Securities and Exchange Commission

<sup>21</sup> U.S. Commodity Futures Trading Commission

<sup>22</sup> The Securities and Exchange Commission, Thailand

<sup>23</sup> Securities Commission, Malaysia

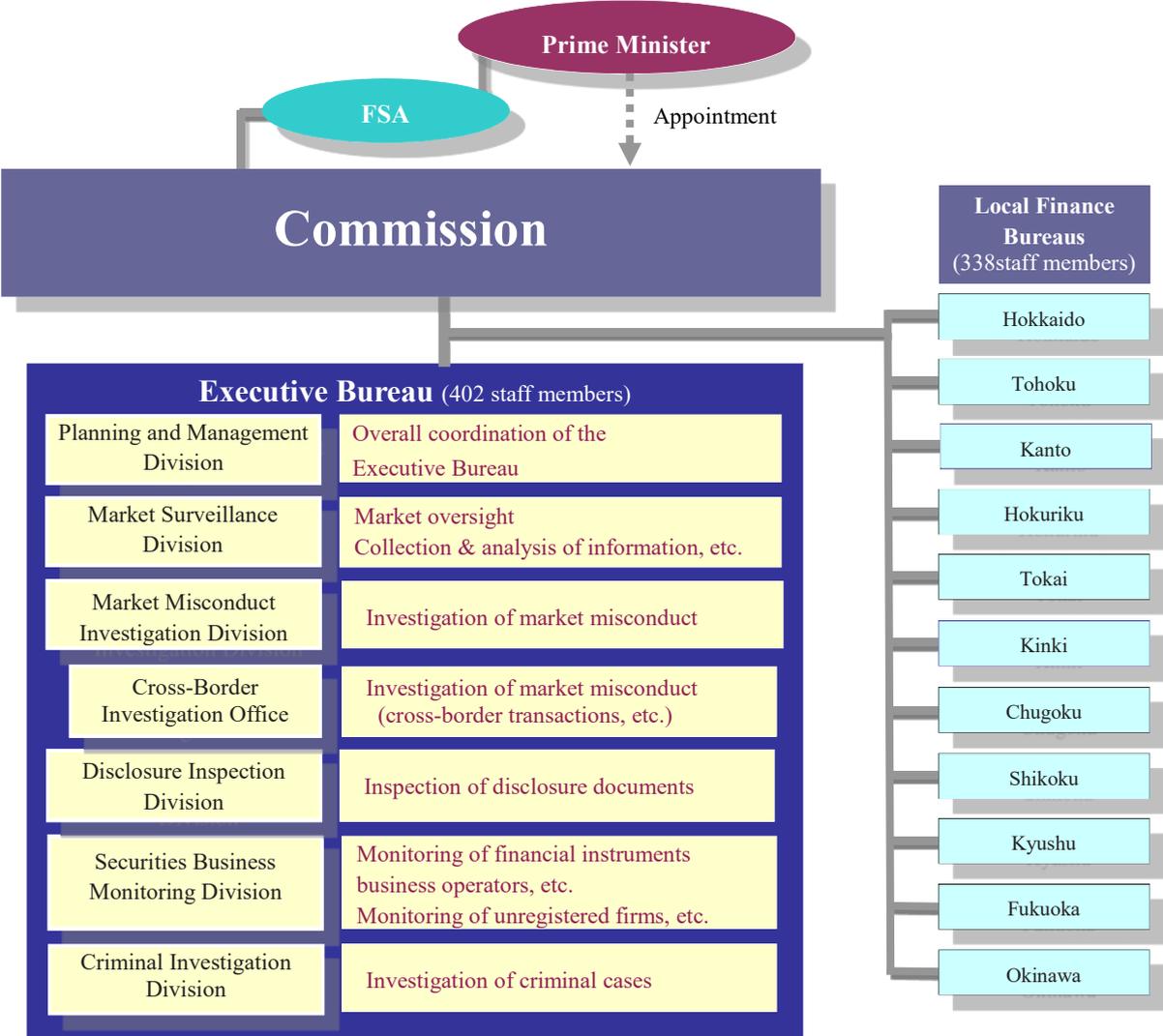
<sup>24</sup> State Securities Commission of Vietnam

# Appendices



Table 1

Organization

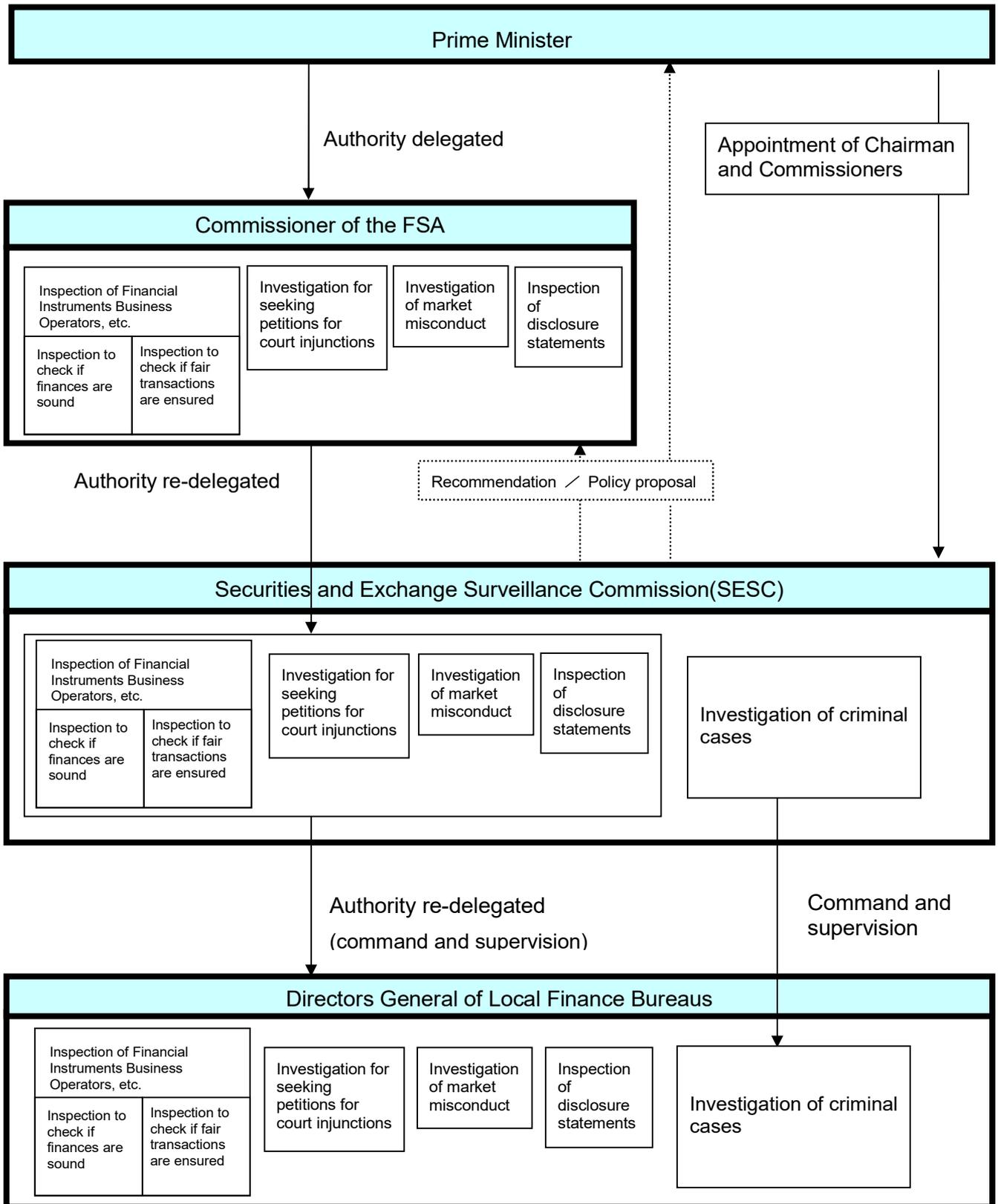


Note1: Staff members of Executive Bureau are quota as at the end of FY2019.

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))

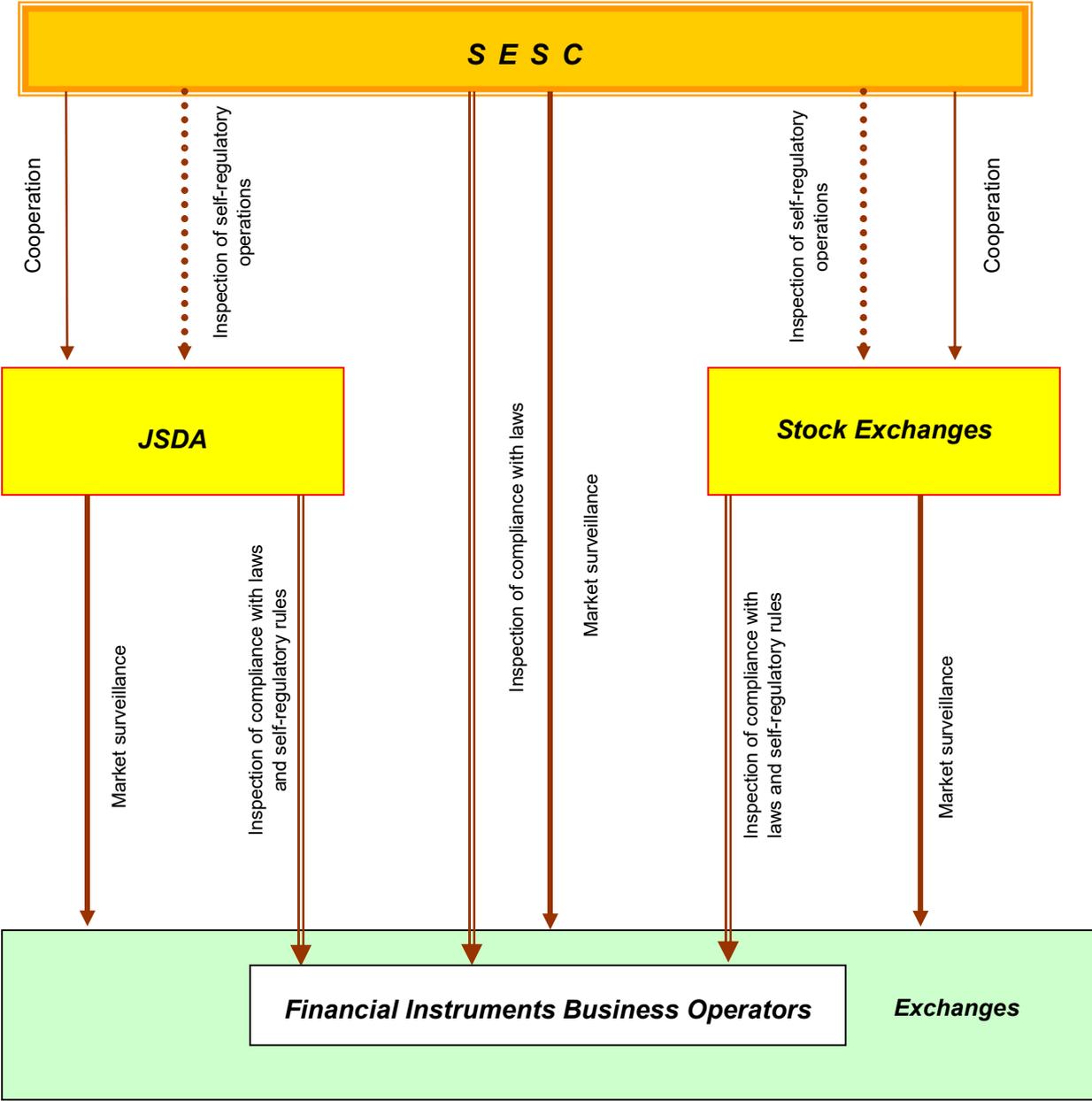
(Note 2) For an investigation of a criminal offence, the SESC directs and supervises the Director General of a Local Finance Bureau or the Director of its branch office. The SESC may, deeming it necessary for investigating a criminal offence, direct and supervise firsthand an official of a Local Finance 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 2013	2014	2015	2016	2017	2018	Total
Category								
	Criminal charges	167	6	8	7	4	8	200
	Recommendations	774	66	59	91	38	54	1,082
	Recommendations based on securities inspections	480	16	18	35	10	11	570
	Recommendations to pay administrative monetary penalty (market misconduct)	210	42	35	51	26	33	397
	Recommendations to pay administrative monetary penalty (false statements in disclosure statements, etc.)	80	8	6	5	2	10	111
	Recommendations for order to submit revised report, etc.	4	0	0	0	0	0	4
	Announcement of results of inspection of persons making notification for business specially permitted for qualified institutional investors	25	17	17	23	4	0	86
	Petition for a court injunction, etc., against unregistered business operator or solicitation without the filing of securities registration statements	8	6	3	1	2	2	22
	Proposals	23	1	0	0	0	2	26
Securities inspections	Financial instrument businesses operators	2,682	206	128	37	25	55	3,133
	Type I financial instrument businesses operators	2,057	77	61	16	19	35	2,265
	Type II financial instrument businesses operators	172	72	32	9	2	7	294
	Investment management firms Investment advisories/agencies	453	57	35	12	4	13	574
	Registered financial institutions	344	1	1	0	0	3	349
	Persons making notification for business specially permitted for qualified institutional investors	53	31	30	20	0	4	138
	Financial instruments intermediaries	31	18	19	2	0	4	74
	Credit rating agencies	7	2	0	0	0	0	9
	Self-regulatory organizations	26	3	3	0	0	0	32
	Investment corporations	45	2	1	1	0	1	50
	Other	7	3	3	1	0	1	15
	Total	3,195	266	185	61	25	68	3,800
	Market oversight	12,635	1,084	1,097	1,142	1,099	1,052	18,109

## 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.

September 14, 2018

Securities and Exchange Surveillance Commission

## **Monitoring Priorities for Securities Businesses (July 2018-June 2019)**

### **Introduction**

The missions of the Securities and Exchange Surveillance Commission (SESC) are: (1) ensuring market integrity and transparency / 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 businesses<sup>1</sup>) is to ensure investors' confidence in the markets. For this purpose, the SESC encourages FIBOs<sup>2</sup> to enhance self-discipline to perform their function as market intermediaries and to operate properly in compliance with relevant laws, regulations, and market rules.

In "*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 mission for the period. For this measure, the SESC has been collaborating with relevant departments of the Financial Services Agency (JFSA).

This document outlines the basic monitoring policy for FIBOs and sets forth the areas of focus in the monitoring activities, in the 2018-2019 business year.

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

#### **(1) General environment surrounding securities businesses**

The global economy continues to recover gradually. However, signs of change, which include the normalization of the extraordinary monetary easing measures

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<sup>1</sup> "Monitoring of securities businesses" in this document includes both on-site and off-site monitoring. On-site monitoring means inspections conducted on site, while off-site monitoring means a wide range of monitoring activities carried out by the SESC, Local Finance Bureaus and others, other than on-site inspections, which may include interviews with and reports from FIBOs and information collection through exchanges of opinions with relevant parties.

<sup>2</sup> 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 notifying engaging in business specially permitted for qualified institutional investors, credit rating agencies, and other entities.

adopted after the global financial crisis and sharp declines in the previously firm share prices, are beginning to show in Europe and the U.S.

The Japanese financial capital markets have seen slowdown in the increase of share prices and share trade volume, although share prices still remain at high levels. Interest rates continue to remain at historically low levels.

These circumstances make it difficult for FIBOs to secure earnings under the traditional business models that rely on fee income. Some investors' move to pursue products with higher returns was abused in a case where a FIBO's sale of high-risk products to individual investors without sufficient explanations on risks subsequently materialized as problems, and a case where unregistered business operator lured investors by the promise of high returns and caused damage.

Cyberattacks continue to be a threat to FIBOs. In July 2017, a large volume of personal information was leaked due to cyberattacks targeting a website operated by a foreign currency margin transactions business operator.

## (2) Approach to monitoring securities businesses

Securities businesses subject to the SESC's monitoring currently total approximately 7,000. These firms offer an increasingly diverse and complex set of services and products and include businesses that have yet to introduce adequate basic control environments for compliance and investor protection.

Regulatory authorities must therefore make best efforts to conduct effective and efficient monitoring of securities businesses and to promptly identify risks that could undermine investors' confidence based on the risk characteristics of FIBOs and with the limited human and other resources.

The SESC will continue implementing a strategy of selecting the businesses subject to on-site monitoring based on the off-site risk assessment of all securities businesses. The SESC carries this out in collaboration with the relevant bureaus of the JFSA including an analysis of the business environment covering economic and industrial trends and an entity's business model.

In conducting on-site monitoring, the SESC aims to not only point out problems and to take actions such as to make recommendations for administrative disciplinary actions, but also to analyze the whole picture of the problems to identify their root causes, so that businesses can address them and prevent their recurrence.

Furthermore, if the need to improve business operations or other potential issues are identified before any problem materializes, the SESC will share the findings with the monitored business and urge them to build effective internal

control environments or take other actions to address the issues.

### (3) Activities in the last business year

In the last business year, the SESC conducted off-site monitoring focusing on changes in the business models of FIBOs. The SESC identified potential issues as the themes to be examined and reviewed the actual conditions through on-site monitoring where it was necessary to comprehend further details.

As a result of this approach, the SESC identified a case where a securities company, who is required to sufficiently examine risks and other characteristics of a new product and create an appropriate control environment for solicitation and sales before its launch, had discovered inadequacies in their screening practices and inappropriate solicitation and sales activities only after risks had materialized. The SESC also identified cases that some securities companies had problems with control environments for basic compliance.

With respect to investment management business operators, the SESC examined, among other things, their approach to customer-oriented business conduct, control environments for conflict of interest management and the effectiveness of liquidity management for assets included in funds, with a focus on major investment management business operators.

With respect to Type II FIBOs, investment advisors/agencies, and persons notifying engaging in business specially permitted for qualified institutional investors (QII business operators), the SESC identified high risk businesses from among the large number of businesses falling under these categories and carried out on-site monitoring as needed based on the analysis of risks associated with their products and information provided by outside sources. As a result of the on-site monitoring, the SESC found problematic cases in terms of investor protection; for instance, some businesses had made false or misleading representations on their websites.

Furthermore, the SESC sought court injunctions to force the cessation and suspension of activities of unregistered businesses that caused a large amount of damage to general investors through their investment advisory services or solicitation for investment in funds.

### (4) Policy for activities in the current business year

As it is becoming increasingly difficult for the traditional fee income-dependent business model to secure earnings in the Japanese financial capital markets,

FIBOs have begun changing their business models. They do so by, for instance, starting new businesses and expanding their product lineups to include overseas financial products and higher-return funds in response to investor expectations for higher-return products.

In light of this situation, in the current business year, the SESC will assess risks focusing on the afore-mentioned trend. In particular, the SESC will proactively conduct on-site monitoring for in-depth examinations where it is necessary to comprehend further details in the event:

- ① a relevant law and/or regulation is breached or there is a deficiency in business operations that requires a prompt in-depth examination;
- ② a financial instrument is offered with an unclear risk profile, necessitating an examination of its solicitation activities;
- ③ the actual situation of business operations is not fully comprehended from an information analysis based on off-site monitoring (including where there is a long period between examinations); and
- ④ there is a possible serious problem concerning investor protection (e.g. inadequacy in the segregated management of customer assets).

Furthermore, the SESC will actively collect and analyze information on businesses that carry out financial instruments exchange business without proper registration, conduct investigations in collaboration with relevant agencies, and seek court injunctions to cease and suspend activities that violate the Financial Instruments and Exchange Act (FIEA) so as to contain the spread of damage to investors.

## 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 in accordance with the “*Strategic Directions and Priorities.*”

- ① AML/CFT (Anti-Money Laundering/Combating the Financing of Terrorism) measures
- ② Sufficiency of cyber security measures
- ③ Implementation status of measures to realize customer-oriented business conduct
- ④ Efforts to upgrade trade surveillance of High Frequency Trading

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

### 3. Monitoring strategies for various FIBO 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) Major securities business groups<sup>3</sup>

The SESC will continue sustained monitoring on the organization status of governance and control environments for risk management that support global business operations and efforts to establish a sustainable business model. In addition, the SESC will swiftly conduct on-site monitoring where it is necessary to confirm the actual sales practices at sales offices.

For securities businesses under the three mega banking groups, given their intention to expand their customer bases through banking and securities collaboration, the SESC will also monitor their control environments for conflict of interest management in addition to the above.

#### (2) Foreign securities firms

The SESC will continue sustained monitoring on the impact of international financial regulations on the business models of the Japanese offices of foreign securities firms and changes in their control environments for risk management. In addition, the SESC will monitor whether foreign securities firms have internal control environments in place that accurately respond to Japanese laws and regulations, given the growing trend of outsourcing internal control operations overseas as part of group strategy.

In light of the prolonged low-interest-rate environment, the SESC will also examine the trends of products sold to Japanese financial institutions and other investors and the risks of these products.

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<sup>3</sup> Major securities business groups: Japanese securities companies with global operations

(3) Online securities firms

The SESC will examine online securities firms' efforts to prevent system errors and to ensure speedy recovery and to provide alternative means for service delivery upon occurrence of errors. In addition, the monitoring will cover changes in product offerings and the status of control environments in preparation for the launch and expansion of face-to-face sales activities in collaboration with independent financial advisors (IFAs) and regional financial institutions.

(4) Second-tier securities firms, regional securities firms

The SESC will examine, among other things, the organization status of business operations in response to changes to each firm's product lineup and profit structure, against the background of the outflow of customer funds through the aging of customers and inheritance. In addition, the SESC will examine the impact any change to the management structure or major shareholders may have on the business models of these securities firms.

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

The SESC will examine the sufficiency of investor protection measures against foreign exchange fluctuations. In addition, the SESC will examine the control environments for settlement risk management of FX transactions business operators including their preparation status for improving capital adequacy through stress testing and for improving their transaction data reporting system.

(6) Investment management business operators

The SESC will examine the effectiveness of governance functions, control environments for management and other points of monitoring from aspects such as improving the investment management abilities of investment management business operators, particularly concerning large operators. In addition, the SESC will examine the business operations of private REIT operators and discretionary investment management business operators with a high proportion of individual and pension fund customers, from aspects such as the management of conflicts of interest and liquidity risk management.

(7) Investment advisors/agencies

The SESC will examine whether any misleading advertisements are used or

if any solicitation activity is conducted using false explanations.

(8) Type II FIBOs and QII business operators

For Type II FIBOs (including social lending business operators) and QII business operators, the SESC will conduct monitoring with a focus on funds advertising high returns and actual existence of business project to be invested. In addition, the SESC, based on the aforesaid monitoring and the analysis of information provided by investors and other sources, will promptly conduct on-site monitoring on operators who are deemed high risk.

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

For other securities businesses, including registered financial institutions, credit rating agencies, 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

To prevent damage to investors caused by 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 and suspend their 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 relevant organizations

The SESC will continue working closely with Local Finance Bureaus (LFBs) from the planning stage of on-site monitoring. If a case that involves multiple LFBs occurs, the SESC will strive to enhance its guidance and coordination functions by, for instance, working out ways to collect and share information and considering appropriate monitoring methods.

The SESC will also continue collaborating closely with relevant organizations including SROs by, for instance, exchanging information in a timely manner. Sharing information and perspectives on issues as needed will contribute to the efficient monitoring of securities businesses and ensuring market fairness and transparency.

## 5. Dissemination of monitoring results and other initiatives

The SESC will provide FIBOs with feedback on problems and best practices found in the monitoring of securities businesses to encourage their voluntary improvement efforts, in cooperation with the relevant departments of the JFSA if necessary.

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

## Logo of Securities and Exchange Surveillance Commission



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