

August 6, 2021

Securities and Exchange Surveillance Commission

## Monitoring Priorities for Securities Businesses (July 2021 - June 2022)

Based on the recent environment surrounding financial instruments business operators (FIBOs), the Securities and Exchange Surveillance Commission (SESC) has compiled the Monitoring Priorities for Securities Businesses for Business Year 2021<sup>1</sup>, setting out industry-wide monitoring priorities and those by size and type for the monitoring of securities businesses.<sup>2</sup>

### 1. Environment surrounding FIBOs

#### (1) Environment surrounding FIBOs

Amid the declining birthrate and aging population, securities companies focusing on face-to-face sales operations continue to see the aging of customers and an outflow of customer assets accompanying inheritance, etc. Given the intensifying race to cut brokerage commissions and the impact of the COVID-19 pandemic, the business environment is growing severer for securities companies that depend on face-to-face sales operations and brokerage commission revenue.

In line with digitalization, FIBOs are expanding sales operations through non-face-to-face channels and providing instruments using security tokens and other new technologies as well as new services using smartphone applications. In markets, high-speed traders' share of exchange-based transactions has remained high. Non-exchange-based transactions through dark pools and proprietary trading systems have been increasing.

International interest has remained high in Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) measures. Based on the fourth mutual evaluation of Japan by the Financial Action Task Force (FATF), FIBOs are required to take AML/CFT measures.

#### (2) Changes to regulatory frameworks for FIBOs

In the previous business year, the following changes to regulatory frameworks for

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<sup>1</sup> Business Year 2021 is from July 2021 to June 2022

<sup>2</sup> "Monitoring of securities businesses" in this document covers both inspection and monitoring. "Inspection" means monitoring based on Article 56-2 of the FIEA, while "monitoring" refers to monitoring other than inspection.

FIBOs were seen:

- (i) New measures to further promote customer-oriented business conduct, reviewing financial services in the super-aged society

Based on discussions at the Capital Market Working Group of the Financial System Council, the Principles for Customer-Oriented Business Conduct (hereinafter, “FD [fiduciary duty] Principles”) and the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. (hereinafter, “Supervision Guidelines”) have been revised to enhance the effectiveness of the FD Principles and clarify the principle of suitability, while follow-up for aged customers has been added to a self-regulatory organization (SRO) ’s guidelines concerning sale by solicitation to aged customers. These changes urge FIBOs to further develop customer-oriented business operations.

- (ii) Establishing guidelines for preventing illegal access in Internet transactions

Given that illegal access to online securities firms has led to illegal withdrawals of customers’ money and customer information leaks, SROs have formulated guidelines for preventing illegal access in Internet transactions to prevent such illegal acts and allow customers to conduct transactions with a sense of security, urging FIBOs to improve security levels of Internet-based trading systems.

- (iii) Measures to improve transparency in dark pool trading

Based on discussions at the Capital Market Working Group of the Financial System Council, the Cabinet Office Order on Financial Instruments Business, etc. (hereinafter, “Cabinet Office Order”) and the Supervision Guidelines have been revised to improve transparency in dark pool trading amid the growing availability of dark pool transactions for retail investors, requiring business operators routing customer orders to dark pools to develop their business management framework, etc..

- (iv) Measures accompanying the realization of an Integrated Exchange

As the realization of the Integrated Exchange paves the way for commodity derivatives traders to fully participate in the framework of the Financial Instruments and Exchange Act (hereinafter, “FIEA”), the SESC will cooperate with a SRO to monitor these traders’ development of internal control environments.

- (v) Establishing a notification system for financial service intermediary businesses and investment management businesses for foreign investors in Japan

As the Act on Sales, etc. of Financial Instruments and the FIEA have been amended to create a notification system for financial service intermediary

businesses and investment management businesses for foreign investors in Japan, these new businesses will be added to securities businesses subject to the SESC monitoring.

(3) Findings through monitoring of securities businesses in the previous business year

Through the monitoring of securities businesses in the previous business year, the SESC found that some FIBOs were transforming their business models or internal control environments in response to changes in their business environment.

In response to the impact of the COVID-19 pandemic, some FIBOs developed work-from-home measures for the purpose of preventing infections from spreading. In this respect, FIBOs are required to develop appropriate internal control environments regarding business operations, compliance management, and information management for employees working from home.

(i) Type I FIBOs

While the promotion of customer-oriented business conduct made progress, inadequate investment solicitation practices were identified, including salespersons' solicitation of customers to change investment policies and purchase high-risk financial instruments. Some major securities business groups had risk management issues, including massive losses on specific overseas transactions.

Some online securities firms proactively diversified products or services or promoted capital or business alliances with others to differentiate themselves from others and secure stable earnings sources amid an intensifying race to cut brokerage commissions. On the other hand, illegal access to online securities firms by outsiders leading to illegal withdrawals of customers' money and customer information leaks was seen, indicating the need for enhancing information security and cybersecurity management environments.

Some regional securities firms reformed business administration arrangements and models due to changes in major shareholders.

Some foreign currency margin transaction business operators were identified as making advertisements including indications that were significantly contradictory to the facts or as violating a ban on re-solicitation.

(ii) Investment management business operators

In an identified case, an investment management business operator was unaware of the investment arrangements, the substantiality of investment methods and the facts regarding management methods at an investment target

for an investment trust that the business operator established to invest in foreign securities in the form of fund of funds, failing to implement sufficient research for appropriate investment decisions and investment asset management. While most of the assets in the investment trust were to be deposited at a prime broker, the investment management business operator failed to check the prime broker's actual segregated management, remaining unaware of the facts regarding the management of investment assets. The investment management business operator was thus identified as failing to fulfil the duty of due care of a prudent manager for investment trust beneficiaries.

(iii) Type II FIBOs

A Type II FIBO that solicits customers to acquire shares of a fund for investment in a lending project was found to have failed to comply with the purpose of use of funds indicated to investors. The Type II FIBO had extremely defective control environments for governance and business operation, using false indications and misleading indications regarding important matters to solicit customers' investment in the absence of effective loan examination and monitoring.

(iv) Unregistered business operators

Without being registered as a FIBO, a business operator was soliciting customers to acquire financial instruments categorized as shares of an overseas collective investment scheme.

## 2. Industry-wide monitoring strategies

Based on the environment surrounding FIBOs and the "*JFSA priorities*" and other policies published by the Financial Services Agency (JFSA), the SESC will verify the following matters for all types of FIBOs in cooperation with relevant JFSA divisions:

(i) Customer services under the impact of COVID-19

For instance, the SESC will verify customer services, including follow-up for customers possessing financial instruments with wildly fluctuating prices, malicious transactions taking advantage of investor anxiety, and responses to fundraising demand under the impact of COVID-19.

(ii) Developing internal control environments focusing on appropriate investment solicitation based on the clarification of the principle of suitability and establishing customer-oriented business conduct

For instance, bearing in mind the possibility of inappropriate sales practices, such

as soliciting customers for financial instruments that fail to meet their attributes or investment purposes, and leading them to pay excessive brokerage commissions, the SESC will verify the development of internal control environments, including services for aged customers. The SESC will also examine initiatives for customer-oriented business conduct at the sales front as necessary.

- (iii) Business model and market changes under the falling birthrate and aging population, progress in digitalization, etc. and the development of internal control environments responding to such changes

For instance, the SESC will verify the impacts of business model changes, such as the expansion of non-face-to-face sales and the provision of new products and services on FIBOs' business management, and the development of internal control environments based on these impacts.

The SESC will also endeavor to grasp order routing and execution status across multiple markets (stock exchanges, proprietary trading systems and dark pools) and find any issues from the viewpoint of ensuring fairness and transparency of markets and protecting investors.

On the other hand, in case a FIBO continues depending on traditional face-to-face sales, the SESC will examine the sustainability of the business model and the impact of the falling birthrate and aging population on financial and other business management

- (iv) Sufficiency of cybersecurity measures, and the status of risk management in systems amid progress in digitalization
- (v) Firm establishment of internal control environments for AML/CFT
- (vi) Implementation of measures to improve or prevent the recurrence of matters pointed out in results of internal audits or examinations by SROs

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

The SESC will also cooperate with relevant parties in considering monitoring approach in line with the revision of regulations regarding the firewall between banking and securities businesses.

### 3. Monitoring strategies for various FIBO business models

Based on the environment surrounding FIBOs, the SESC will examine a FIBO if the SESC has concerns regarding its violation of relevant laws and regulations or inadequate segregated management of customer assets, taking into considerations the scale of

FIBOs' businesses and type of service. The examination will be focus on the following points.

(1) Major securities business groups<sup>3</sup>

Given changes in customer services under the impact of COVID-19 and massive losses on specific overseas transactions for some major securities business groups, the SESC will verify the development of control environments for governance and risk management that support global business operations, and efforts to build sustainable business models, taking into account each group's business environment.

If it is necessary to confirm actual sales practices at sales offices, the SESC will swiftly inspect relevant sales offices.

In addition to the points listed above, as for the three mega banking groups' securities companies, the SESC will verify control environments for conflict-of-interest management, considering their efforts to expand their customer bases through cooperation between banking and securities businesses.

(2) Foreign securities firms

The SESC will verify the development of internal control environments that respond to the overseas outsourcing of back-office operations under group strategies and control environments for system risk management.

In light of the prolonged low interest rate environment, the SESC will also examine the development of control environments for managing sales of financial instruments to Japanese financial institutions and other investors.

(3) Online securities firms

As illegal withdrawals of customers' money through illegal access to online securities firms have been identified, SROs have formulated guidelines for preventing illegal access, requiring the securities industry as a whole to enhance security. In such a situation, the SESC will verify the development of control environments for system risk management, including cybersecurity measures, at online securities firms and other types of securities companies providing online trading.

The SESC will also examine the development of internal control environments at online securities firms in line with their business model changes, such as initiatives to eliminate brokerage commissions, increases in products, and launch and expansion of face-to-face sales activities in collaboration with independent financial

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

advisors.

(4) Semi-major/regional securities firms

While semi-major and regional securities firms have faced a severe business environment, including the outflow of customers' assets through the aging of customers and inheritance, as well as the impact of COVID-19, the SESC in its inspections heretofore has identified inappropriate investment solicitation and other problems regarding investor protection. Given this, the SESC will examine steps taken to conform to the principle of suitability.

The SESC will also verify the effectiveness of internal control environments from the viewpoint of business models or governance at securities firms where major shareholders or business management systems have changed.

(5) Foreign currency margin transactions business operators

As for foreign currency margin transactions business operators that are required to enhance security along with online securities firms, the SESC will verify their control environments for system risk management, including cybersecurity measures.

Given that past inspections have identified advertising regulation violations and sales/solicitation problems at these business operators, the SESC will also examine their development of adequate internal control environments.

Furthermore, the SESC will verify their disclosure of risk information, the reflection of stress test results to capital and the development of transaction data storage and reporting arrangements.

(6) Investment management business operators

As for investment management business operators, the SESC will conduct risk-based examinations of their grasp of investment status and their development of control environments for investment management (including those outsourced) and conflict-of-interest management.

(7) Investment advisors/agencies

As for investment advisors/agencies, based on the past inspection results, the SESC will continue examining whether or not any problematic practices concerning investor protection are conducted, such as misleading advertisement and solicitation through false explanation.

(8) Type II FIBOs and business operators, etc. engaging in specially permitted businesses for qualified institutional investors

As for Type II FIBOs (including sellers of loan-type funds) and business operators, etc., engaging in specially permitted businesses for qualified institutional investors, the SESC will conduct risk-based examinations, including through analysis of information from investors, focusing on funds advertising high returns and the substantiality of investment target projects, considering a case that a Type II FIBO failed to comply with the purpose of use of funds indicated to investors.

(9) Independent financial advisors and other securities businesses subject to monitoring

As for independent financial advisors, the SESC will examine the adequacy of their investment solicitation and the sufficiency of their control by their entrusting FIBOs, considering online securities firms' launch and expansion of face-to-face sales activities in collaboration with these advisors.

As for other securities businesses, including registered financial institutions, credit rating agencies, securities finance companies and SROs, the SESC will conduct risk-based monitoring in light of their particular business types.

(10) Unregistered business operators

To prevent the expansion of damage to investors caused by unregistered business operators, the SESC will proactively exercise its investigative authority to seek court injunctions on their illegal conduct. The SESC will also enhance information dissemination, including the public disclosure of their names, their representatives' names and their illegal conduct, as well as the issuance of alerts and messages to investors regarding transactions with unregistered business operators. The SESC will also proactively collaborate with relevant JFSA divisions, Local Finance Bureaus (LFBs), investigative authorities and the Consumer Affairs Agency.

In addition to the above, the SESC will verify FIBOs' responses to changes in regulatory frameworks cited in 1. (2).

#### 4. Approach to monitoring securities businesses

(1) Inspection

Securities businesses subject to the SESC monitoring currently total approximately 7,700. These firms widely differ in size, services and products, and some of them

have yet to introduce adequate basic control environments for compliance and investor protection. Therefore, it is important for the SESC, with its limited human resources and based on *“the Basic Principles of Securities Business Monitoring”*, to conduct effective, efficient monitoring of securities businesses according to their risk characteristics and promptly identify risks.

The SESC will continue to select FIBOs for inspection based on risk assessment from various viewpoints, including business types and sizes as well as business models, in cooperation with relevant JFSA divisions. Inspection will be mainly conducted in cases where it is necessary to comprehend further details, such as:

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

On the occasion of inspection, the SESC will conduct digital forensics for in-depth verification according to the characteristics of individual FIBOs and matters for verification.

The SESC aims not only to point out problems and take actions, such as making recommendation for administrative disciplinary actions, but also to analyze the whole picture of the problems to identify their root causes, so that effective measures to prevent problems will be developed. Furthermore, if the need to improve business operations is identified before any potential issues materialize, the SESC will describe it as “Items to be noted” in the notification of completion of inspection to share the awareness with the inspected businesses and urge them to build effective internal control environments or take other actions to address the issues.

To prevent the spread of COVID-19 infections, the SESC will, for the time being, conduct inspection with the utmost care for the inspection targets’ COVID-19 infection prevention measures, including through using remote conference systems.

Also, to keep the depth of securities business monitoring, the SESC will further enhance cooperation with SROs, including through mutual complementation regarding inspection and matters for verification by business type.

## (2) Cooperation with relevant organizations

To make maximum use of their respective functions, the SESC and LFBs will work closely from the planning stage of monitoring and inspection, including information sharing and exchange of opinions, and conduct joint inspection as needed. If a case that involves multiple LFBs occurs, the SESC will exercise its guidance and coordination functions by, for instance, collecting and sharing information and considering appropriate monitoring methods. The SESC will also focus on necessary training to support such activities of LFBs.

The SESC, relevant JFSA divisions and LFBs will collaborate to share information and conduct simultaneous inspection regarding the inspection of financial service intermediary businesses as well as cryptocurrency exchange service providers trading in over-the-counter cryptocurrency derivatives.

The SESC will also continue collaborating closely with SROs and share detected matters and current awareness with them by exchanging information in a timely manner, promoting securities business monitoring effectively and efficiently to ensure market fairness and transparency, and to protect investors.

## 5. Dissemination of inspection results and other initiatives

The SESC will encourage voluntary improvement efforts by providing FIBOs with feedback on problems and their root causes found in the inspection, and sharing inspection results with inspected FIBOs' audit-related officials and outside directors at review meetings, in cooperation with relevant JFSA divisions as needed.

The SESC will also endeavor to provide the public with information about the SESC's perspectives in a specific and straightforward manner, including through the publication of the *"Overview of Monitoring of Securities Businesses and Case Studies."*