

Basic Inspection Policy and Inspection Program for Business Year 2008

I. Basic Inspection Policy

1. Basic Concept

The principle mission of the Securities and Exchange Surveillance Commission (SESC) is to ensure fairness in the market and maintain the trust of investors and other market participants. The SESC attempts to fulfill this mission by conducting an adequate and fair inspection on market intermediaries, or “financial instruments firms.”¹ The Commission also expects financial instruments firms to play the critical role of gatekeepers; they are expected to contribute to ensuring the confidence of investors and the fairness and soundness of financial and capital markets, while disciplining themselves as professionals familiar with the market environment. The SESC inspection, through dialogues with the firms, is intended to enhance their awareness of their role as gatekeepers.

The financial and capital markets in Japan face a dramatically transforming landscape. This involves changes both in market environment, with the arrival of more complex, diversified and globalized financial instruments and transactions, and also in market infrastructure, including the legislative reform in the Financial Instruments and Exchange Law (FIEL). In order to respond to such changes, and to revitalize the Japanese market to improve its international competitiveness, the Financial Services Agency (FSA) has launched a new initiative on “Better Regulation”, aimed at improving the quality of Japanese financial regulations in the interest of market participants - an initiative similarly observed in many other jurisdictions today.

The SESC is committed to proactively aligning itself to these domestic and overseas trends. The Better Regulation aims at a set of regulations that is better for market participants. A better inspection, in this context, implies more efficiency and more effectiveness in inspection.

¹ Otherwise noted, the term, “financial instruments firms” in this document encompasses both the registered “financial instruments businesses” and the “registered financial institutions,” as defined in the Financial Instruments and Exchange Law (FIEL).

“An efficient inspection” means more than merely conducting an in-depth inspection with a sharper focus on risks. An inspection is truly “efficient” when it harnesses and adds to the self-improvement efforts by financial instruments firms, built on their enhanced internal control systems and forged by market discipline. Also, an inspection is “effective” when it leads to sustainable improvement in the firms’ internal control systems, and to the confidence of market participants. Needless to say, indispensable elements to such inspection are two-way dialogues with financial instruments firms, and close coordination with relevant regulatory agencies.

More specifically, the SESC’s efficient and effective inspection will be achieved on the following terms:

- 1) An adequate combination of principle-based inspection focused on the improvement in financial instruments firms’ business management systems, and the rule-based verification of their compliance to market rules.
- 2) A sharper risk focused approach, with a more forward-looking mind-set, in selection of financial instruments firms to be inspected, as well as of areas to be inspected.
- 3) More emphasis placed on interactive dialogues with the financial instrument firms, with a view to encouraging their voluntary efforts toward developing stronger internal control functions.
- 4) More transparency and predictability in inspection methodology, for example through the publication of the revised “Inspection Manuals for Financial Instruments Firms.”

The recent subprime loan crisis has revealed the global extent of focuses of the securitized instruments market and its attendant risk management issues. One of the SESC inspection will thus be on the securitization process, namely underwriting examination, risk management, sales management and other related control systems of financial instruments firms that arrange, underwrite, and market such securitized instruments.

With the objective of encouraging the financial firms to provide more diverse and higher quality financial services, the FIEL was revised to relax the firewall regulations among securities firms, banks and other firms, on condition that their internal control systems for managing conflict of interest be enhanced. The SESC will accordingly be charged to look into this new area of disciplines.

Furthermore, the SESC intends to continue issuing recommendations to the FSA, where necessary, on required disciplinary actions based on its individual

inspection results. The Commission will also monitor developments in financial and capital market rules, and will forward policy proposals to the FSA, as necessary.

2. Implementation Policy of Inspection for Business Year 2008

(1) Achieving an efficient and effective inspection

1) In-depth inspection focused on risks

More flexibility and efficiency will be added to inspection programs, by focusing giving more sharply on risks. By collecting and analyzing information on the financial and capital market trends, the SESC will flexibly select and prioritize financial firms to be inspected, considering their inherent problems and positions in the market. Where cross-sectoral issues related to the financial and capital markets are identified, special inspection with a cross-cutting theme (a thematic review) will be conducted. A special inspection (a follow-up inspection) will also be implemented to verify the improvement of problems stated in a business improvement order, or pointed out in a previous inspection.

2) Enhancement of cooperation with relevant regulatory agencies

The SESC will reinforce its back office supporting function for its inspectors, in order to improve the efficiency and effectiveness of inspection. In addition, the Commission will promote joint inspection and the exchanges of inspectors, to further the sharing of inspection methodologies and problem awareness with inspectors in the Local Finance Bureaus.

Furthermore, as described below, the SESC will improve cooperation with relevant regulatory agencies to enhance the sharing of problem awareness and of viewpoints.

- The SESC will collaborate with Supervisory Departments in the FSA to promote the mutual sharing of problem awareness and information. The Commission will also, under proper division of roles, exchange information that is obtained through supervision yet is equally useful for inspection, and information that is obtained through inspection but is equally useful for supervision.
- The SESC will promote necessary cooperation with the Inspection Bureau of the FSA. The two bodies will share problem awareness, and, if required, implement simultaneous inspection, and exchange information on financial instruments firms that constitute a financial conglomerate, to achieve efficient

and effective inspection.

- The SESC will work with Self Regulatory Organizations (SROs) to enhance necessary collaboration, and exchange information on both regular and ad-hoc bases, in order to ensure that their industrial and self-regulatory functions are well in place.
- The SESC will enhance cooperation with overseas regulators, through the exchanges of information on foreign affiliated firms and domestic firms with overseas bases that are subject to inspections.

3) Publication of the Revised Inspection Manuals

The recent revision on the FIEL will relax the firewall regulations, including the restriction on interlocking executive positions within a financial group. At the same time, the revised law will require the group to strengthen its conflict of interest management system, as a part of the group-wide internal control system. The SESC, mandated to inspect these new disciplines, will revise and publish its "Inspection Manuals for Financial Instruments Firms," to ensure transparency in how the inspection on this point will be conducted.

4) Verification of self-improvement efforts of financial instruments firms (appropriate internal control system)

When identifying any deficiencies in firms' business operations, the SESC will not only verify their compliance to explicit rules, but also assess the quality of their internal control system, with reference to the criteria published in the Inspection Manuals, "The Model Management of Financial Instruments Firms." As the firm's internal control system is an important element in assessing the basic posture of the firm, the Commission will verify the effectiveness of its functioning. Any deficiencies will be assessed in light of the responsibility that the firm as a whole should assume.

5) Focus of a group-wide inspection

In a group-wide inspection focused on intra-group transactions, the SESC will verify the quality of internal control function, regarding the handling of customer information and the management of conflict of interests. Particularly, as the recently revised FIEL will require financial groups to improve their conflict of interest management systems, the SESC will verify their effectiveness, in terms of, for example, whether or not customers' interests are unduly undermined by group companies' transactions. Furthermore, the Commission may take account of the entire group of the firm, including its holding company, to assess whether

the inspected firm is subject to any undue influence from any other companies in the group.

(2) Areas of inspection focus

1) Verification of market intermediary functions of financial instruments firms

To develop and maintain a fair, transparent and high quality financial and capital market, it is extremely important that financial instruments firms play the role of gatekeepers. They are expected to prevent the market participation of those who intend to abuse and misuse the market, through the adequate management of customers, trade examination, underwriting examination (due-diligence) and other activities. The SESC will verify whether and to what extent they are playing their roles appropriately.

As a part of this assessment, the SESC will verify how inspected financial instruments firms are developing their information gathering system to prevent transactions by anti-social forces. Regarding suspicious transaction reporting, the Commission will verify the institutional effectiveness of the firms' checking systems, including the development of internal screening criteria. Also, the SESC will inspect whether the identity verification measure is properly implemented at the time of opening securities accounts.

Furthermore, to encourage the adequate functioning and the healthy development of capital markets, the Commission will assess whether underwriting operations, including due diligence, information management, trade management and distribution are appropriately executed from the viewpoint of protecting investors. As for financial instruments firms that arrange, underwrite and market the securitized instruments such as CDOs, the SESC inspection will focus on their underwriting examination, risk management and sales management systems.

Moreover, the SESC will verify whether the firms are consistently and properly controlling IT system risks and other operational risks, to prevent system failures and other problems from hindering the smooth operation of securities transactions. In cooperation with the relevant agencies, the Commission will take appropriate measures with regard to the computerization of stock certificates in financial instruments firms.

2) Verification of the management of undisclosed corporate information (Prevention of unfair insider trading)

In order to prevent unfair insider trading, the Commission will verify whether financial instruments firms and registered financial institutions are properly managing undisclosed corporate information. More specifically, the SESC will verify whether the firms are establishing an effective management system, involving the registration of corporate information, the restriction on stock trading by officers and employees, the firewalls of the information access, and the trading examination.

3) Verification concerning appropriateness of asset management business

While asset management firms are commissioned by investors to manage assets for investors' interest, it is very difficult for individual investors to directly check the state of management firms. Accordingly, the SESC will inspect asset management firms' compliance to the relevant rules, including fiduciary duty, and prudent management duty, to protect the interest of investors. Particularly, in the case of asset management firms that manage assets of real-estate investment companies, the Commission will focus on the compliance with fiduciary duty and other laws, as well as the effectiveness of their conflict of interest management systems and due-diligence.

4) Verification of conduct that may hinder fair price formation

Fair price formation underlies the development of fair, highly transparent and healthy financial and capital markets. The SESC will inspect not only misconduct that may hinder fair price formation, but also the effectiveness of trade management systems of the firms.

As for financial instruments firms operating online trading, or providing electronic facilities for DMA (direct market access), the Commission will verify to what extent their trade management systems are adequately adapted to the peculiar nature of the electronic transactions, i.e., they can feed customer orders directly and instantly into the market.

5) Verification concerning the state of soliciting investors and the appropriateness of segregation.

To protect investors and secure fair sales attitudes, the SESC will assess whether or not investors are appropriately solicited, and verify how investors are solicited. Especially in terms of the suitability rule, the Commission will verify whether accountability is fulfilled, taking full account of customers' knowledge and

experiences, and other factors. In addition, the SESC will verify whether there are any indications in advertisements, the means by which investors first access the financial instrument, that may cause misperceptions about its investment effects and changes in market forces.

Also, the SESC will verify the appropriateness of segregation measures between clients' and firms' assets, and the financial soundness of firms, particularly with regard to foreign exchange margin trading operators (FX firms).

6) Verification for the appropriate exercise of function of SROs

As for SROs, the SESC will verify whether self-regulatory operations are satisfactorily effective, whether their functions are appropriately executed, and whether they have a system to adequately execute functions. Specifically, the Commission will verify the establishment of their self-regulatory rules for their members, and their regulatory enforcement such as on-site and off-site reviews, penalties, and listing examination and management. In verifying listing examination and management, the SESC will focus on their measures designed to prevent anti-social forces from intervening in their markets, including the collection of information on the involvement of anti-social forces in issuing and listed companies.

Furthermore, in consideration of the significance of exchanges as a part of market infrastructure, the Commission will focus on verification of whether they are establishing an appropriate and effective management system for IT system risks and other risks.

7) Verification concerning financial firms to be newly inspected, and new financial instruments

In line with the recent expansion of the scope of inspection, the SESC intends to make continuous efforts to gain knowledge and understanding on the situations of firms and instruments, which became newly subject to inspection, including collective investment schemes (investment funds), and to develop inspection methods and expertise, to protect the interest of investors.

8) Improvement of problems identified in previous inspections

There have been a limited number of cases where the inspected firms were not forthcoming in improving the deficiencies identified by the inspections. The SESC will thus systematically verify the improvement of issues pointed out in

the previous inspections, and will strictly deal with the cases where similar problems are recurring.

II. Basic Inspection Program

Type I Financial Instruments Businesses, and Registered Financial Institutions:

130 firms (including 110 firms to be inspected by the Local Financial Bureaus) [98 (82)]

Asset management firms, and Investment advisories/agencies:

70 firms (including 35 firms to be inspected by the Local Financial Bureaus) [52 (26)]

Self regulatory organizations:

To be inspected as needed

Type II Financial Instruments Businesses:

To be inspected as needed

(Note 1) The above-mentioned figures are subject to change, as a result of changes in inspections program, including the implementation of special inspections.

(Note 2) Figures in [] are the number of firms to be inspected by the end of March 2009. From the 2009 business year, the Basic Inspection Policy and Inspection Program are scheduled to be released on a fiscal year basis (from April through March), instead of the current business year basis (from July through June).