Tentative translation

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Securities and Exchange Surveillance Commission

Monitoring Priorities for Securities Businesses (July 2023 - June 2024)

Based on the recent environment surrounding financial instruments business operators (FIBOs), and the commitment of the Securities and Exchange Surveillance Commission (SESC), as stated in its Strategy & Policy 2023-2025 published on January 27, 2023, to continuing securities inspections based on a risk-based approach and making a proactive response to cases where investors are harmed, the SESC has compiled the priorities for its securities business monitoring[1] for Business Year 2023.[2]

1. Environment surrounding FIBOs, etc.

(1) Environment surrounding FIBOs

The "Basic Policy on Economic and Fiscal Management and Reform 2023," formulated in June 2023, states that the government will implement the "Doubling Asset-based Income Plan" through such means as fundamentally expanding and perpetuating the NISA (Nippon Individual Savings Account) program, establishing a public organization for financial and economic education, and promoting customer-oriented business conduct, and will formulate a policy plan on fundamental reform of the asset management business, etc. within this year. In order to facilitate households' stable asset building, it is important to achieve a virtuous cycle of funds wherein the fruits of the growth of the Japanese economy and companies are distributed to households. For that purpose, FIBOs are continuously required to properly ensure customer-oriented business conduct at each stage of the composition, sale, management, etc. of financial instruments and fulfill their expected roles sufficiently.

As the business environment significantly changes along with progress in digitalization and other factors, FIBOs are developing sustainable business models through such means as partnering with other securities and financial companies and providing services that meet the changing market environment and customer needs.

As warnings have been repeatedly issued to financial institutions to call for enhanced cybersecurity measures under the initiative of top management amid

[1] "Securities business monitoring" in this document covers both inspection and monitoring. "Inspection" means activities based on Article 56-2 of the Financial Instruments and Exchange Act, while "monitoring" refers to activities other than inspection.

[2] Business Year 2023 is from July 2023 to June 2024

the increasing risk of cyberattacks, FIBOs are continuously required to strengthen their system risk management, including cybersecurity.

International interest has remained high in Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) measures. As Japan follows up on the results of the FATF 4th Mutual Evaluation and looks ahead to the 5th Mutual Evaluation, FIBOs are continuously required to take AML/CFT measures.

(2) Changes to regulatory frameworks for FIBOs

Since the previous business year, regulatory frameworks, etc. for FIBOs have been under review as follows. In light of such moves, FIBOs are required to ensure customer-oriented business conduct and strengthen investor protection.

(i) Measures for ensuring customer-oriented business conduct

Based on discussions held by the "Customer-Oriented Business Conduct Task Force" of the Working Group on Capital Market Regulations under the Financial System Council, there are moves toward developing a regulatory framework for ensuring customer-oriented business conduct that takes into consideration the best interests of customers, etc. and enhancing the provision of information to customers. A Self-regulatory Organization (SRO) revised its guidelines to ensure appropriate solicitation and sale of complex structured bonds, etc. to customers, and it disseminated the ideal form of disclosure of development costs (theoretical price) and disclosure and analysis of risks and returns.

(ii) Response to the progress in digitalization, etc.

Based on discussions held by the Working Group on Capital Market Regulations under the Financial System Council, there are moves toward developing a regulatory framework, such as prohibiting type II FIBOs that provide social lending, etc. from publicly offering funds that do not guarantee the delivery of investment reports, and applying sale and solicitation regulations under the Financial Instruments and Exchange Act to token rights based on specified joint real estate venture contracts. Also, as the development of an environment for trading platforms for unlisted securities and security tokens is in progress, a PTS operator is working toward launching a PTS for security tokens.

(iii) Development of provisions concerning ESG investment trusts

As the issue of “greenwashing” has been pointed out globally in recent years, the Comprehensive Guidelines for Supervision of Financial Instruments

Business Operators, etc. were partially amended to specify in detail matters to be verified regarding ESG information disclosure for publicly offered investment trusts.

(iv) Clarification of trustee responsibilities of investment management business operators

Based on discussions held by the Working Group on Capital Market Regulations under the Financial System Council, for the purpose of clarifying trustee responsibilities of investment management business operators with regard to investment trusts that are virtually managed by external managers, such as in the form of fund of funds, an SRO revised its rules to specify matters to be observed and noted when investing in investment trust securities or outsourcing investment instructions.

(3) Findings through the securities business monitoring over the past business year

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

(i) Type I FIBOs, registered financial institutions, independent financial advisors

With regard to customer-oriented business conduct, in the context of sales of financial instruments through bank-securities collaboration, the SESC found that a regional bank-affiliated securities company failed to develop a sufficient internal control environment to follow the principle of suitability, and engaged in inappropriate solicitation and sale that conflicted with the principle of suitability. The SESC also found that the regional bank as a registered financial institution failed to develop an appropriate internal control environment for providing financial instruments intermediary services and engaged in problematic conduct in terms of investor protection, which eventually led to the above-mentioned issue at the regional bank-affiliated securities company. In addition, the SESC found that a financial instruments intermediary service provider as an outsourcee of an FIBO sold financial instruments with inappropriate solicitation and that the FIBO failed to sufficiently manage the financial instruments intermediary service provider.

The SESC found that a large securities company engaged in market manipulation in relation to block trades, had deficient trade screening, and conducted business in collaboration with banks inappropriately.

(ii) Investment management business operators

The SESC found that an investment management business operator who uses outsourcing failed to properly manage and administer its investment assets, such as establishing fund-of-funds type investment trusts without sufficient due diligence in accordance with product characteristics.

The SESC also found that some asset management companies who operate REITs, infrastructure funds, or other investment corporations violated the duty of diligence, such as by conducting inappropriate property surveys or property earnings management, and that they had deficient conflict-of-interest control systems, including an inability to verify the appropriateness of transactions with interested parties.

(iii) Investment advisors/agencies

The SESC found that an investment advisor/agency violated laws and regulations, such as posting false information on an e-mail magazine available free of charge to subscribers to solicit an investment advisory contract.

(iv) Type II FIBOs

The SESC found that a Type II FIBO set up webpages for publicly offered funds that invest in money lending businesses, but posted false information regarding collateral and borrowers' financial conditions and solicited page viewers to obtain equity in those funds.

(v) Unregistered business operators

The SESC found that some unregistered business operators conducted over-the-counter derivatives transactions or made public offering or private placement of foreign bonds without registration as FIBOs.

2. Industry-wide monitoring priorities

Considering the environment surrounding FIBOs, and the Japan Financial Services Agency's (JFSA's) policies, such as *"The JFSA Strategic Priorities,"* the SESC will examine the following industry-wide themes in cooperation with relevant JFSA divisions:

(i) Internal control environments with a focus on appropriate investment solicitation based on the principle of suitability, and appropriate sales operations based on customer-oriented business conduct

For instance, with regard to the sale of complex or highly-risky products, not limited to structured bonds, the SESC will examine whether FIBOs develop and appropriately implement internal rules concerning customer targeting and explanation, whether they appropriately monitor compliance with such internal rules, and whether their actual sales operations are consistent with their policies on the principle of customer-oriented business conduct.

(ii) Business model changes along with progress in digitalization, etc., and the development of internal control environments in response to such changes

For instance, the SESC will examine the impacts of FIBO's business model changes, such as the expansion of non-face-to-face sales and the provision of new products and services, on their business management, and will verify that they have appropriate internal control environments in response to these changes.

On the other hand, as for those FIBOs whose business models remain dependent on traditional face-to-face sales, the SESC will examine the sustainability of such business models and the financial and other business impacts of the changing market conditions and customer needs.

(iii) Sufficiency of cybersecurity measures (including countermeasures against unauthorized access in online trading), and system risk management (including management of system development and operation and management of trustees) in response to progress in digitalization

(iv) Firm establishment of internal control environments for AML/CFT

(v) Implementation of measures to improve or prevent the recurrence of matters pointed out in internal audits or SRO examinations

In addition to the above, the SESC will flexibly examine other themes in accordance with concrete efforts being made in light of the environment surrounding FIBOs, such as the implementation of the "Doubling Asset-based Income Plan" and fundamental reform of the asset management business, etc., as well as in response to changes in the relevant environment.

3. Monitoring priorities by FIBOs' size and business type

Considering each FIBO's size and business type, as well as the environment surrounding them, the SESC will focus on the following items, regarding which FIBO's could violate relevant laws and regulations or harm investor protection, such as with inadequate segregation of customer assets.

(1) Major securities business groups[3]

Considering the business environments surrounding each major securities

[3] Major securities business groups: Japanese securities companies with global operations

business group, the SESC will continue to verify that they have appropriate control environments for governance and risk management that support global business operations, and that they are working to build sustainable business models.

Given that deficiencies have been found in their business operation, including trade screening, the SESC will verify that they have appropriate internal control environments, including those for detecting and preventing market misconduct.

If necessary, the SESC will swiftly inspect relevant sales offices to examine actual sales practices there.

As for the three mega banking groups' securities companies, in addition to the above, the SESC will coordinate with relevant JFSA divisions in verifying that they have appropriate control environments for managing customer information in line with their promotion of bank-securities business relationships.

(2) Foreign securities firms

The SESC will verify that the foreign securities firms have appropriate internal control environments in response to the overseas outsourcing of back-office operations as part of their group strategies, and that they have appropriate control environments for system risk management. The SESC will also verify that they have appropriate control environments for managing sales of financial instruments to Japanese financial institutions and other investors.

(3) Online securities firms

Given the recent increasing risk of cyberattacks, the SESC will verify that online securities firms have appropriate control environments for system risk management, including cybersecurity measures.

The SESC will verify that they have appropriate management of outsourcing contractors, in line with their business model of using financial instruments intermediary service providers to expand face-to-face sales activities. The SESC will also verify that, as some online securities firms move to eliminate trade commissions, they have appropriate internal control environments, including effective trade management that can deal with rapid increases in newly opened accounts and transaction volume.

(4) Semi-major/regional securities firms (including regional bank-affiliated securities companies)

The SESC found that, amid the severe business environment, such as the outflow of customers' assets through aging and inheritance, the impact of intensifying fee competition and digitalization, some semi-major/regional securities firms were engaging in inappropriate investment solicitation and other problematic practices in terms of investor protection. Therefore, the SESC will examine whether they are following the principle of suitability.

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

(5) Foreign currency margin transactions business operators

Given the recent increasing risk of cyberattacks, the SESC will verify that the foreign currency margin transaction business operators have appropriate control environments for system risk management, including cybersecurity measures.

The SESC will also verify that they comply with relevant advertising regulations and have appropriate internal control environments for sales and solicitation.

(6) Investment management business operators

The SESC will verify the investment management business operators' actual investment practices and control environments for managing investment (including those outsourced) and conflicts-of-interest.

(7) Investment advisors/agencies

The SESC will verify that investment advisors/agencies are free from problematic practices in terms of investor protection, 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

The SESC will focus on funds claiming high returns and the existence of investment projects, including through analysis of information from investors.

(9) Financial instruments intermediary service providers and other securities businesses subject to monitoring

Considering that some online securities firms are expanding face-to-face sales activities in cooperation with independent financial advisors, the SESC will verify that their investment solicitation is conducted appropriately and managed sufficiently by their entrusting FIBOs.

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

(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 file a petition with the court for a prohibition and stay order against their illegal conduct. The SESC will also enhance information dissemination, including the public disclosure of their and their representatives' names and illegal conduct, as well as the issuance of alerts and messages to investors regarding transactions with unregistered business operators. In addition, the SESC will proactively coordinate with relevant JFSA divisions, Local Finance Bureaus (LFBs), investigative authorities and the Consumer Affairs Agency.

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

4. Approach to the securities business monitoring

(1) Inspection

Securities businesses subject to the SESC monitoring currently total approximately 8,200. They widely differ in size, services, and products, and some 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 collaborate with relevant JFSA divisions to identify and assess risks at FIBOs for risk-based inspection, and will continue to be proactive in ascertaining their actual situation through inspections mainly for the following cases. Also, the SESC will conduct inspections in a flexible manner, including by narrowing down items for verification as necessary.

(i) an FIBO has breached a relevant law and/or regulation or has concerning business operations, which necessitates prompt in-depth verification;

(ii) an FIBO offers a financial instrument with an unclear risk profile, which necessitates examination of its solicitation activities;

(iii) an FIBO's actual business operations cannot be fully comprehended through monitoring-based information analyses alone (including where it has been long since the last time the FIBO was inspected); or

(iv) an FIBO poses a possible serious problem in terms of investor protection (e.g., inadequate segregation of customer assets).

In its inspections, the SESC will endeavor to conduct verification and point out problems in a practically meaningful manner, and it will conduct in-depth verification by using digital forensics according to each FIBO's characteristics and issues.

Rather than merely pointing out problems and taking such actions as making a recommendation for administrative disciplinary actions, the SESC will analyze the whole picture of the problems to identify their root causes, to help develop effective measures to prevent recurrence. Furthermore, if the SESC identifies the need to improve business operations before any potential issues materialize, it will describe such items as "Items to be noted" in the notification of completion of inspection, to share the awareness with the inspected FIBOs to encourage actions such as building effective internal control environments.

(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.

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

With regard to security tokens, the SESC will analyze information, including how they are issued and distributed, in collaboration with relevant JFSA divisions.

The SESC will continue close collaboration with SROs, share detected matters and awareness in a timely manner, and thereby conduct its securities business monitoring effectively and efficiently, to ensure market fairness and transparency, and investor protection.

5. Dissemination of inspection results and other initiatives

The SESC will encourage voluntary improvement efforts by inspected FIBOs, including, as necessary, by providing feedback on problems and root causes found, and by sharing inspection results also with their audit-related staff members and outside directors at review meetings.

The SESC will also endeavor to provide information about its perspectives in a specific and straightforward manner, including through the *“Overview of Securities Business Monitoring and Case Studies.”*