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September 2017

TECHNICAL NOTE—REGULATION AND SUPERVISION OF SECURITIES FIRMS

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REGULATION AND SUPERVISION OF SECURITIES FIRMS

Prepared by
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Japan, led by Gaston Gelos. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

BoJ	Bank of Japan
CMG	Crisis Management Group
CPA	Certified Public Accountant
D-SIB	Domestic Systemically Important Bank
FFAJ	Financial Futures Association of Japan
FIBO	Financial Instruments Business Operator
FIEA	Financial Instruments and Exchange Act
G-SIB	Global Systemically Important Bank
IAAB	Investment Advisory and Agency Business
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
JFSA	Japan Financial Services Agency
JGAAP	Japanese Generally Accepted Accounting Principles
JIAA	Japan Investment Advisers Association
JIPF	Japan Investor Protection Fund
JITA	Japan Investment Trusts Association
JPX	Japan Exchange Group
JPX-R	Japan Exchange Regulation
JSDA	Japan Securities Dealers Association
MMoU	Multilateral Memorandum of Understanding
PTS	Proprietary Trading System
SESC	Securities and Exchange Surveillance Commission
SRO	Self-Regulatory Organization
TSE	Tokyo Stock Exchange
USGAAP	United States Generally Accepted Accounting Principles

EXECUTIVE SUMMARY

Japanese securities firms consist of a very heterogeneous group of firms, ranging from major global players to purely domestic firms that conduct only limited activities. At one end, the firms include two major independent securities groups designated as Domestic Systemically Important Banks (D-SIBs) as well as the securities subsidiaries of the Japanese megabanks that are G-SIBs. Foreign-owned securities firms that are part of global G-SIB banking groups also have a significant presence in Japan, accounting for more than half of the trading value at Tokyo Stock Exchange (TSE). The rest of the almost 2,000 firms range from very small investment advisers to medium-sized firms providing Internet-based trading services to retail clients.

The authorities take this heterogeneity in the securities firms' business models into account in organizing their regulatory and supervisory work. Sufficient supervisory coverage is achieved through the combination of work done by the government regulators and the various self-regulatory organizations (SROs). While the overall supervisory structure is complex, the authorities and SROs strive to work in a coordinated manner to achieve their common objectives, while trying to reduce overlaps. Nevertheless, the authorities should continue to enhance their cooperation to ensure effective supervision as well as engage with the SROs to benefit from the SROs' ability to focus on investor protection and market fairness.

The authorities are transitioning to a new supervisory approach that combines more intensive offsite monitoring and risk-based onsite inspections. The new approach, if applied in a sufficiently consistent manner across the authorities, enables to focus better on emerging risks and how firms' governance and controls address those risks. However, it is important to address the transitional challenges and carefully balance offsite and onsite activities. This includes providing sufficient training and guidance to the Local Finance Bureaus in implementing the new approach. In addition, onsite inspections should remain an important supervisory tool.

The supervision of the two major Japanese securities groups and the Japanese subsidiaries of global banking groups deserves special attention, given the domestic and cross-border interconnectedness of these firms. The authorities should continue to ensure that the supervisory teams for the major Japanese groups have access to sufficient number of experienced staff. It is also important to continue to enhance the existing international cooperation in the supervision of Japanese firms' overseas operations and foreign-owned firms' activities in Japan. Recommended tools include continuous enhancement of joint onsite monitoring of Japanese securities firms' foreign business and cooperation with the foreign authorities responsible for the parent banks of Japanese securities firms.

The supervision of the other securities firms builds on stringent requirements on client asset holding and segregation that have been used as a basis for tailoring the current prudential framework. The prudential requirements for securities firms address the risks arising from the most systemically important firms in an internationally comparable manner. On the other hand, the

requirements for other firms have features that differ from the models used elsewhere, for example, by applying consolidated supervision only above a certain threshold. Reflecting the importance given to the asset segregation requirement, it is recommended that the authorities enhance supervision of compliance with it. The recommended review of the prudential framework—to be conducted within medium-term—should ensure that the framework appropriately addresses the financial stability and investor protection risks potentially arising from smaller firms' activities. Such a review is needed to ensure that the framework remains appropriate when markets change.

Table 1. Japan: Main Recommendations on Regulation and Supervision of Securities Firms		
Recommendation	**Priority**	**Timing[1]**
Division of regulatory responsibilities		
Continue to enhance cooperation between regulators to ensure effective supervision of securities firms (Japan Financial Services Agency (JFSA), Securities and Exchange Surveillance Commission (SESC), Local Finance Bureaus).	High	I
Continue to engage with the SROs to benefit from their ability to focus on investor protection and market fairness (JFSA, SESC, Local Finance Bureaus).	Medium	I
Regulation		
Review the prudential regulatory framework for all securities firms to ensure that it appropriately addresses the financial stability and investor protection risks, striving towards the global best practice (JFSA).	Medium	MT
Supervision		
Enhance supervision of compliance with the client asset segregation requirement (JFSA, SESC, Local Finance Bureaus).	High	NT
Continue to ensure that the teams responsible for the supervision of the systematically important securities firms have access to sufficient number of experienced staff (JFSA, SESC).	High	I
Continue to provide sufficient training and guidance to the Local Finance Bureaus during the transition to the new supervisory approach (JFSA, SESC).	High	I
Continue to use onsite inspections as an important complement to more intensive offsite monitoring (JFSA, SESC).	High	I
Continue to enhance onsite monitoring of Japanese securities firms' overseas operations jointly with foreign supervisory authorities (JFSA, SESC).	High	I
Continue to ensure that the cooperation with the foreign supervisory authorities responsible for the global banking groups sufficiently covers their Japanese securities subsidiaries (JFSA, SESC).	Medium	NT
[1] I=immediate (within one year); NT=near term (1–3 years); MT=medium term (3–5 years).		

INTRODUCTION[1]

1. Japanese securities markets rank among the largest in the world. With its equity market capitalization of US$4,955 billion, the Japan Exchange Group's (JPX) Tokyo Stock Exchange (TSE) is the third largest exchange in the world after the U.S. New York Stock Exchange and NASDAQ. In terms of value of trading, TSE ranks sixth with the annual equity trading value of US$5,618 billion.[2] Derivatives trading is less significant, with Osaka Exchange (also part of JPX) ranking as 17th in the world in 2016 with about the tenth of the trading volume of the largest derivatives exchange, CME Group in the United States.[3] While foreign market participants collectively have a strong presence in Japan through subsidiaries and branches, the major securities firms are Japanese. Large domestic banks also have important securities subsidiaries that provide securities services that banks are not permitted to undertake in Japan. At the other end of the spectrum, Japan has a large number of small securities firms providing investment advice and limited intermediary services.

2. This note reviews the functioning and effectiveness of the regulation and supervision of securities firms[4] in Japan, using the relevant International Organization of Securities Commissions (IOSCO) documents as benchmarks.[5] The note also discusses the regulatory and supervisory framework for the securities business conducted by banks and other financial institutions. Where relevant, the discretionary investment management business conducted by securities firms is covered, whereas the management of collective investment schemes (investment trusts and investment corporations in Japan) by securities firms is outside the scope of the analysis.[6]

3. The note's analysis is based on various information sources. They include the authorities' response to a questionnaire; a limited review of the relevant Japanese legal and regulatory framework, in particular the Financial Instruments and Exchange Act (FIEA); and discussions with the authorities and market participants. The applicable Japanese legal and regulatory framework is very complex and there are no up-to-date English translations for some areas. Therefore, the analysis of the Japanese authorities' ability to address the risks arising from securities business has had to rely

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[1] The main author of this note is Ms. Eija Holttinen, Senior Financial Sector Expert from the Monetary and Capital Markets Department of the IMF. The onsite work supporting the findings and conclusions was conducted during April 6-27, 2017. The information in this note is current as of April 2017.

[2] Source: World Federation of Exchanges, https://www.world-exchanges.org/home/index.php/files/52/Annual-Statistics-Guide/439/WFE-Annual-Statistics-Guide-2016.xlsx.

[3] Source: JPX.

[4] In Japan, securities firms are referred to as Financial Instruments Business Operators (FIBOs). This term is used later in the note in lieu of the term securities firm, particularly when referring to precise legal requirements applicable to various types of FIBOs.

[5] The IOSCO documents used are: Principles 29-32 of the Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, August 2013; A Comparison and Analysis of Prudential Standards in the Securities Sector, February 2015; and Recommendations Regarding the Protection of Client Assets, January 2014. The note also takes into account Appendix II, Annex 3 (Client Asset Protection in Resolution) of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions.

[6] Collective investment schemes are covered by IOSCO Principles 24-28 and several other IOSCO Standards.

on information provided by the authorities and market participants to a larger extent than is typically the case.

4. The analysis focuses on the regulatory requirements and supervisory practices that are the most essential for the safety and soundness of securities firms. After describing the overall market and regulatory structure in the following section, the note discusses the relevant elements of the regulatory framework. The section on supervision reviews how the Japanese supervisory authorities and SROs monitor the risks arising from securities business and are able to address the risk of a failure of a securities firm. Conclusions and recommendations are presented after each section and the main recommendations are summarized in Table 1 above.

MARKET AND REGULATORY STRUCTURE

A. Firms Permitted to Conduct Securities Business

Legal framework

5. Both securities firms and other financial institutions can conduct securities business in Japan. The scope of the permitted activities varies on the basis of their registration type.

Financial Instruments Business Operators

6. Generally, a firm seeking to provide securities services must apply for registration as a Financial Instruments Business Operator (FIBO).[7] There are four main types of financial instruments business and a FIBO registration can cover one or more of them (see Annex I for a detailed description):[8]

- Type I financial instruments business, which is brokerage, dealing, and corporate finance activities in a wide variety of "liquid" financial instruments;[9]

[7] In addition to FIBOs, Financial Instruments Intermediary Service Providers need to be registered under the FIEA. Financial Instruments Intermediary Service is provided under delegation from a FIBO and under the responsibility of the FIBO. Therefore, the regulatory and supervisory framework for these service providers is not discussed in this note. Finally, Qualified Institutional Investor Business Operators can provide services to Qualified Institutional Investors as defined in the FIEA subject to a notification procedure.

[8] Each business has various subcategories differentiated on the basis of the type of service and financial instrument (security, financial derivative, commodity derivative) in which services can be provided. The application for registration has to include information on the subcategory in which services are provided, but the registration itself reflects only one or more of the four main categories.

[9] Shares, government bonds, corporate bonds, and other securities defined in Article 2(1) of the FIEA.

- Type II financial instruments business, which is brokerage and dealing in and distribution of certain "illiquid" financial instruments;[10]
- Investment advisory and agency businesses (IAAB); and
- Investment management business.

Branches of foreign securities firms

7. If a foreign securities firm does not wish to establish a subsidiary in Japan, it can conduct securities business through a branch, subject to registration as a FIBO. The registration categories are the same as for Japanese FIBOs. Registration requires the firm to establish a physical presence (office) in Japan (see paragraph 83).

Cross-border provision of certain securities services

8. In certain cases, foreign securities services providers may conduct their business without specific registration or permission and without having an office in Japan. This applies if investment advisory services are provided to a FIBO registered for investment management business. Another exemption is provided for services where the counterparty of a transaction (other than OTC derivatives transaction) is a FIBO, the government or Bank of Japan.

9. Provision of certain other services is also possible without an office in Japan, subject to receiving a specific permission. A foreign securities services provider may receive a permission to participate in an underwriting contract, provided that the applicant has at least three years of experience in the same type of business in a foreign jurisdiction and a minimum of JPY 500 million of capital.

Other financial institutions

10. Banks and other financial institutions can conduct only limited securities business. Without registration under the FIEA, they can only invest on their own account as permitted by other laws (such as the Banking Act) or invest on behalf of a trustee under a trust agreement. By registering under the FIEA, they may, in addition, distribute unit trusts and trade in Japanese government bonds and related derivatives.

Nature and scope of business

11. The nature and scope of the business conducted by the different categories of market participants varies significantly on the basis of their registration type. Out of the total of 1,942 Japanese securities firms, only 25 can conduct all four types of securities business. The

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[10] Beneficial interest and other securities specified in Article 2(2) of the FIEA and related derivatives. These include trust beneficial rights, rights in partnership agreements, anonymous partnership agreements and investment limited partnership agreements.

majority of firms are specialized in Type II financial instruments business and/or IAAB (1,348 firms, see Table 2). Certain securities business can also be conducted by individuals (see Table 2). The number of banks, cooperatives and other financial institutions permitted to conduct securities activities is large, but the scope of their activities is very limited, as discussed above.

Table 2. Japan: Number and Types of Persons Conducting Securities Business

	Number of Registered Persons February 28, 2017		
	Firms	Firms Registered Only for one Business Category[1]	Individuals
Total number of FIBOs	1,942	1,337	31
Type I	286	138	N/A
Type II	1,157	657	1
IAAB	987	475	30
Investment management	350	67	N/A
All four of the above	25	N/A	N/A
Financial institutions			
Banks	152	N/A	N/A
Cooperatives	882	N/A	N/A
Other financial institutions	21	N/A	N/A

Source: JFSA.

[1] In addition, 216 firms are registered only for Type II financial instruments business and IAAB. Therefore, a total of 1,348 firms conduct only relatively narrow securities activities.

12. **Large securities firms engaged in Type I financial instruments business are designated as so called Special FIBOs.** The size is determined based on the total value of the firm's assets. If it exceeds JPY 1 trillion, the firm must notify the JFSA after which it will be treated as a Special FIBO and will become subject to additional requirements under the FIEA, such as consolidated capital adequacy requirements. There are currently 21 Special FIBOs. These include firms belonging to the two major independent securities groups and the main securities subsidiaries of the megabanks. In addition, three other Japanese-owned securities firms and 12 foreign-owned securities firms are Special FIBOs.

13. **The registration category limits the type of business that a FIBO can conduct and, through that, impacts the risks arising from the FIBO's business.** Persons registered for Type I or Type II financial instruments business can deal on their own account, but dealing is limited to the instruments covered by their registration category. This means that firms engaged solely in Type II business create limited systemic risk. Firms engaged in IAAB and investment management business cannot deal on their own account. Investment risk is carried by the investors.

14. A few major securities firms dominate the Type I business. During the fiscal year 2015, the net operating revenue of the firms belonging to the two major independent securities groups accounted for 30 percent of the revenue of all firms engaged in Type I financial instruments business. Together with the megabanks' securities subsidiaries registered for Type I business, they reached 56 percent of the industry's net operating revenue. The major independent securities groups and the megabank subsidiaries typically have some market and counterparty risk arising from their trading operations, which is managed at the group level. In addition, large securities firms' dependence on wholesale funding may expose them to funding risk.

15. After the two major independent securities groups and megabank subsidiaries, foreign-owned securities firms form the next most important group of market participants. While in terms of number of firms, the 71 foreign-owned firms represent fewer than 1/4 of FIBOs registered for Type I business, they are very active in many business areas, including trading and corporate finance activities. An example of their important market share is trading on TSE and Osaka Exchange, where foreign origin firms undertake the majority of trading (Table 3).

16. The rest of the firms engaged in Type I financial instruments business is a heterogeneous group of firms with diverse business models. They include 32 securities firms that are subsidiaries of a total of 28 banks. The rest are independent, small to medium-sized securities firms, often specialized to serving a certain type of client base (e.g., those trading over the Internet). The main source of these firms' operating revenue is typically commissions (Figure 1). More than half of the 286 firms registered for Type I financial instruments business can also provide other securities services.

Conclusions

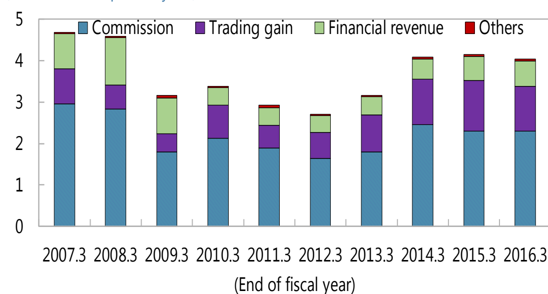
17. The authorities take the above-described heterogeneity in the securities firms' business models into account in organizing their regulatory and supervisory work. This is discussed further below in the sections on regulation and supervision.

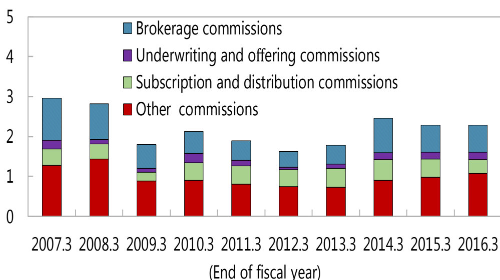
Table 3. Japan: Number of Members and their Market Share in Tokyo Stock Exchange and Osaka Exchange Trading, January 1–November 30, 2016

	Tokyo Stock Exchange		Osaka Exchange		
	Number of Members (as of Nov. 30, 2016)	Market Share, Value of Trading (In percent)	Number of Members (as of Nov. 30, 2016)	Market Share, Number of Equity Derivatives Contracts (In percent)	Market Share, Number of Fixed Income Derivatives Contracts (In percent)
FIBOs					
Japanese owned FIBOs	73	46.93	65	30.86	33.78
Foreign owned FIBOs	15	52.30	13	68.92	55.88
Japanese branches of foreign securities firms	4	0.54	4	0.22	0.54
Other members					
Japanese owned banks, cooperatives and other financial institutions	N/A	N/A	26	N/A	9.81
Regulated remote members by home country	1	0.22	N/A	N/A	N/A
Total	**93**	**100**	**108**	**100**	**100**

Sources: Tokyo Stock Exchange, Osaka Exchange.

Figure 1. Japan: Performance Summary for JSDA Members





Source: Japan Securities Dealers Association.
1/ Firms that were not in business as of the end of March in each year are excluded.

B. Division of Regulatory Responsibilities

Government regulators

Japan Financial Services Agency

18. The JFSA is the integrated financial supervisory authority in Japan, whose role as the regulator of securities business is primarily guided by the FIEA. Its mandate is to ensure the stable functioning of Japan's financial system; the protection of depositors, policyholders and securities investors; and the facilitation of finance. In principle, the Prime Minister is responsible for the regulation and supervision of securities business in Japan. The JFSA's authority vis-à-vis securities firms is derived through delegation from the Prime Minister imposed by the FIEA. Under this arrangement, the FIEA obliges the Prime Minister to transfer ("delegate") most of his authority under the FIEA to the JFSA Commissioner. While exceptions from this delegation obligation can be made under a Cabinet Order, no such exceptions have been made with regard to securities firms.[11] As a result, the JFSA Commissioner is responsible for all regulatory, supervisory and enforcement activities related to securities firms.

19. However, the FIEA provides that the JFSA Commissioner must or may further delegate his authority to other public authorities. The delegation arrangements applicable to the JFSA Commissioner in the FIEA are of four types:

- Authority that the JFSA Commissioner must delegate to the Securities and Exchange Surveillance Commission (SESC) and that he can no longer exercise with the exception of requiring the submission of reports or materials (FIEA Article 194-7(2));
- Authority that the JFSA Commissioner may delegate to the SESC (FIEA Article 194-7(3));
- Authority that the JFSA Commissioner must delegate to the SESC but that he can also exercise directly in parallel to the SESC (FIEA Article 194-7(4)); and
- Authority that the JFSA Commissioner may delegate to the Director General of a Local Finance Bureau (FIEA Article 194-7(6)).[12]

[11] The exceptions relate to exchanges, authorized and certified associations and investor protection funds.

[12] All references in this note to Local Finance Bureaus also include Local Finance Branch Bureaus.

Securities and Exchange Surveillance Commission

20. The SESC was established in accordance with the Act for the Establishment of the Financial Services Agency, but it exercises its authority independently. Its mission is to ensure the integrity of capital markets, protect investors, and contribute to the sound development of markets and sustainable economic growth. It consists of a Chairman and two Commissioners. Each of them is appointed by the Prime Minister with the consent of the upper and lower houses of the Parliament. The SESC exercises its authority under delegation from the JFSA Commissioner. It may sub-delegate some of this authority to a Local Finance Bureau (FIEA Article 194-7(7)). The SESC's Executive Bureau is responsible for its main functions. The Bureau is composed of six divisions: Coordination, Market Surveillance, Inspection, Administrative Monetary Penalty, Disclosure Statements Inspection, and Investigation Divisions. The total number of SESC's staff is 411.

Local Finance Bureaus

21. Local Finance Bureaus, which are regional branch offices of the Ministry of Finance (MoF), also play an important role in the supervision of securities firms. Eleven of them have a Financial Supervisory Division, which conduct supervisory work either under direct delegation from the JFSA Commissioner or under sub-delegation from the SESC. Delegated functions are undertaken under the guidance and supervision of the JFSA Commissioner or the SESC.

Division of responsibilities between the JFSA, SESC, and Local Finance Bureaus

22. All JFSA Commissioner's inspection and investigation authority is formally delegated to the SESC, whereas the Local Finance Bureaus have an important overarching role in the supervision of small- and medium-sized securities firms. The Local Finance Bureaus undertake the registration of all securities firms and conduct the offsite monitoring and onsite inspections of the majority of securities firms (by number of firms). However, the JFSA (in cooperation with the SESC) is directly responsible for the offsite monitoring of the large securities firms, which are determined based on criteria such as the number of branches, number of clients, and value of client assets. On this basis, a total of 321 FIBOs are subject to direct offsite monitoring by the JFSA (in cooperation with the SESC) and onsite inspections by the SESC.[13]

23. On the basis of its supervisory activities, the SESC may recommend enforcement measures to be taken. Such recommendations are made both to the Prime Minister and the JFSA Commissioner and can relate to administrative actions or orders to pay administrative monetary penalties. The SESC may also file formal complaints to public prosecutors if it is convinced that there has been a criminal offence. Further details are presented in the section on enforcement below.

[13] Out of these 321 firms, 78 are registered for Type I financial instruments business, 205 for Type II financial instruments business, 171 for IAAB, and 211 for investment management business. This information is publicly available, since the JFSA issues a notice about each firm that will be subjected to its supervision.

Self-regulatory organizations

24. In addition to government regulators, SROs contribute to the supervision of securities firms in Japan. Under the FIEA, three types of entities can perform self-regulatory functions:

- Associations, which comprise both authorized and certified associations;[14]
- Exchanges (licensed under Article 80 of the FIEA); and
- SROs established by exchanges (authorized under Article 102-14 of the FIEA).

25. All SROs must conduct regulatory, supervisory and disciplinary activities vis-à-vis their members. Authorized associations are required to have rules and controls to prevent and detect violations of laws and regulations or the association's rules. Certified associations must provide their members with guidance, recommendations and other services in order for them to comply with laws and regulations and have rules for ensuring the appropriateness of members' solicitation activities. Exchanges or their self-regulatory organizations must create, amend and repeal self-regulatory rules. All SROs are required to conduct inspections of their members' compliance with laws and regulations, their own rules, and the principle of good faith in transactions. In case of violations by a member, they are required to impose an administrative surcharge, order the suspension or restriction of membership, or expel the member.

Japan Securities Dealers Association

26. Japan Securities Dealers Association (JSDA) is a financial instruments firms association authorized under the FIEA. In addition to its self-regulatory activities, JSDA also provides a vehicle for policy dialogue between the industry, the government and other related parties; conducts and promotes investor education; and implements studies for further developing the market. The total number of JSDA staff was 366 as of April 1, 2017, of which approximately 150 are involved in self-regulatory activities (regulation, inspections, sales representative registration, and disciplinary activities).

27. JSDA's members are engaged in securities-related business and OTC derivatives transactions (excluding financial futures transactions). The members fall into three groups:

- Regular members: FIBOs conducting Type I financial instruments business (262 members as of April 3, 2017);
- Specified business members: FIBOs exclusively engaged in OTC derivatives transactions or equity-based crowd funding (4); and

[14] Authorization of financial instruments firms associations is covered in Article 67-2(2) of the FIEA and certification of financial instruments business associations is covered in Article 78 of the FIEA.

- Special members: registered financial institutions (banks, life insurance companies, general insurance companies, etc.) (211).

28. The JSDA's main self-regulatory activities are:

- Rule-making: establishing and building awareness of self-regulatory rules that apply to members.[15] In its rule-making, the JSDA consults with the JFSA to avoid regulatory duplication and to achieve consistent regulation.
- Inspection and monitoring of members' business activities, internal control systems and compliance with laws and regulations.
- Disciplinary actions: taking actions to punish members that have violated the laws or self-regulatory rules.

Exchanges and their self-regulatory organizations

29. FIEA requires exchanges to conduct self-regulation to ensure fair securities and derivatives markets and to protect investors. They can either undertake such operations themselves or establish an SRO to conduct them under delegation. An SRO needs to be authorized. TSE and Osaka Exchange have delegated their self-regulatory services to Japan Exchange Regulation (JPX-R), which is a subsidiary of JPX. The other regional exchanges (Nagoya, Fukuoka, and Sapporo) undertake their own self-regulatory services.

30. JPX-R is involved in all the self-regulatory functions that TSE and Osaka Exchange are required to have. JPX-R has to give its consent to TSE's and Osaka Exchange's operational rules and other rules that relate to self-regulatory services before the exchanges apply for the JFSA's approval of the rules. JPX-R also organizes qualification examinations for trading participants and conducts inspections of them. TSE has 93 trading participants all of which are securities firms. All 81 securities firm trading participants of Osaka Exchange are also TSE trading participants. In addition, 26 banks and one securities firm trade JGB futures and other similar instruments at the Osaka Exchange. Therefore, JPX-R supervises a total of 120 trading participants.

Certified associations

31. In addition to the above SROs, there are four associations in Japan that have been certified under the FIEA and that conduct self-regulatory activities vis-à-vis their members:

[15] The key rules and guidelines issued by the JSDA applicable to securities firms include: Rules concerning Solicitation for Investments and Management of Customers, etc.; Rules concerning Publication of Over-The-Counter Trading Reference Prices, etc. and Trading Prices of Bonds; Rules concerning Appropriate Implementation of Separate Management of Customer Assets by Regular Members; Guidelines concerning Association Member Analysts' Interviews, etc. with Issuers and Communication of Information.

- *Type II Financial Instruments Business Operators Association:* The association's members are FIBOs registered for Type II financial instruments business. In practice the members are engaged in fund distribution business.

- *Financial Futures Association of Japan (FFAJ):* As of April 30, 2017, FFAJ had 146 members (142 regular and 4 special members). Its regular members are FIBOs and registered financial institutions carrying out financial futures business.

- *Japan Investment Trusts Association (JITA):* As of April 1, 2017, JITA's members included 161 full members that are FIBOs registered for investment management and managing investment trusts as well as 20 supporting members (other securities firms and banks).

- *Japan Investment Advisers Association (JIAA):* JIAA members consist of FIBOs registered for investment management that conduct discretionary investment management business and/or fund management business. In addition, some JIAA members provide only investment advisory or agency services.

Conclusions and recommendations

32. The Japanese regulatory and supervisory structure is fairly complex, but the authorities and SROs' responsibilities appear to sufficiently cover both the prudential and conduct of business supervision of securities firms. The complexity applies both to the allocation of responsibilities between the JFSA, SESC and Local Finance Bureaus and the role the multiple SROs play in the regulation and supervision of the sector. Despite these complexities, the authorities and SROs strive to work in a coordinated manner to achieve their common objectives, while trying to reduce overlaps (see the section on Supervision). While a simpler structure could potentially be more efficient, the current structure does not seem to lead to any significant gaps of coverage, driven by the JFSA's key role in defining the regulatory and supervisory strategy for the entire financial sector. The strong role of the Local Finance Bureaus and SROs ensures that the JFSA and SESC can focus on the supervision of firms that are the most relevant for financial stability.

33. However, the authorities should continue to enhance their cooperation to ensure effective supervision of securities firms. They should also continue to engage with the SROs to benefit from the SROs' ability to focus on investor protection and market fairness.

REGULATION

34. The key regulatory requirements for securities firms are included in the FIEA. The analysis below focuses on securities firms, since the prudential and organizational requirements for banks have been discussed in the detailed assessment of compliance with the Basel Core Principles and those for insurance companies in the technical note on insurance sector regulation and supervision.

A. Prudential Requirements

Capital adequacy requirements

35. The initial capital requirement depends on the type of securities business for which the firm is registered. Securities firms registered only for IAAB are not subject to minimum capital requirements, but must provide a JPY 5 million business security deposit.[16] Minimum capital requirements for securities firms registered for Type I or Type II financial instruments business and investment management business are:[17]

- JPY 3 billion for underwriters of securities with a significant need to manage the risk of loss (i.e., lead underwriters);
- JPY 500 million for other underwriters;
- JPY 50 million for any other Type I financial instruments business and investment management business (other than investment management business solely to qualified investors); and
- JPY 10 million for Type II financial instruments business[18] and investment management business to qualified investors.

36. Risk-based ongoing capital requirements apply only to firms engaged in Type I financial instruments business. Such firms are required to calculate their capital adequacy ratio every business day and report the end of month ratio to the JFSA or relevant Local Finance Bureau by the 20th day of the following month. The JFSA applies the net capital rule approach to determining the capital adequacy requirement on a solo basis to all securities firms registered for Type I financial instruments business. The calculation method is summarized in Box 1.

37. The capital adequacy ratio is not permitted to fall below 120 percent and is subject to close monitoring even above that level. If the capital adequacy ratio falls below 140 percent, the FIBO must immediately notify the JFSA. It must also submit a plan on specific measures to improve the ratio and report without delay when the ratio reaches or exceeds 140 percent. Further trigger levels are applied at 120 and 100 percent, based on automatic alerts created by the reporting system. In such cases the JFSA can take certain actions, if deemed necessary and appropriate in the public interest or for the protection of investors:

[16] The same deposit requirement applies to individuals engaged in IAAB. The deposit is made to the Local Bureau under the Ministry of Justice.

[17] The initial capital must be in the format of shareholders' equity (or equivalent contributions). If a firm is registered for multiple types of financial instruments business, the highest capital requirement applies. In addition, a firm seeking registration for Type I financial instruments business of investment management business (other than to qualified investors) must hold net assets at least equaling the initial capital requirement.

[18] If an individual engages in Type II financial instruments business, he/she is subject to a JPY 10 million business security deposit requirement.

- If the capital adequacy ratio falls below 120 percent, the JFSA may order changes of business methods, order assets to be deposited, or issue orders with respect to matters that are otherwise necessary from a supervisory perspective;

- If the capital adequacy ratio is less than 100 percent, the JFSA may order the suspension of all or part of the firm's business activities during a fixed period of no longer than three months; and

- If the capital adequacy ratio remains under 100 percent after three months has passed since the suspension of business order and the authorities determine that the business lacks a recovery outlook, the JFSA may revoke the registration of the FIBO.

38. The JFSA has taken action when firms have reached the above trigger levels. During fiscal years 2014−16, two firms fell below the 140 percent threshold and one firm below the 120 percent threshold. In the last case, the JFSA issued a business improvement order and a business suspension order.

39. In addition, the JFSA may rescind the registration of a FIBO or order the suspension of all or part of its business activities for a fixed period of no longer than six months in certain other cases relating to the financial condition of a FIBO. Such action may be taken if a FIBO engaging in Type I financial instruments business or investment management business does not have sufficient net assets or where the JFSA has concerns about a FIBO's insolvency considering the state of its business or assets.

40. The securities firms not registered for Type I financial instruments business are not subject to any risk-based capital requirements. The authorities justify this on the fact that such firms are not permitted to hold client assets. However, all securities firms also need to maintain and enhance soundness, including by meeting the initial capital requirement on an ongoing basis. The JFSA and Local Finance Bureaus would be able to identify any capital adequacy deficiencies from the firms' annual business reports. Firms are also required to notify the JFSA or the relevant Local Finance Bureau immediately if their capital falls below the initial capital requirement.

Liquidity requirements

41. The liquidity risk management requirements for FIBOs are largely qualitative. FIBOs registered for Type I financial instruments business are required to have a liquidity risk management framework compliant with the JFSA's Supervisory Guidelines. The Supervisory Guidelines cover both funding risk and market liquidity risk. The Supervisory Guidelines focus on whether the FIBO properly manages liquidity risk, appropriate to the nature and scale of its business. A FIBO should aim at developing a comprehensive control environment for liquidity risk management, properly recognizing and evaluating the risks and establishing a system of checks and balances based on the clear allocation of roles and responsibilities.

42. Despite the lack of specific quantitative requirements, the JFSA monitors the liquidity risk of firms engaged in Type I financial instruments business on a regular basis. Firms must

submit a monthly liquidity report to the JFSA or the relevant Local Finance Bureau. In addition, supervisory staff strive to identify and keep track of the status of a FIBO's liquidity risk and risk management through hearings.

Box 1. Determination of the Capital Adequacy Ratio for FIBOs Registered for Type I Financial Instruments Business

The Japanese legal framework applies a net capital rule approach to determining the capital adequacy requirement for FIBOs engaged in Type 1 financial instruments business. They must hold sufficient net capital to cover the risk-equivalent amount of their market, counterparty and operational risk.

The net capital (non-fixed capital) is determined as follows:

	Assets	Liabilities and capital	
	Liquid assets	Liabilities	
		Non-fixed capital	Own capital
To be subtracted from own capital	(deposits etc.)	(subtract)	
	Fixed assets		
	Deferred assets		

The risk equivalent amount is the sum of the market risk equivalent amount, counterparty risk equivalent amount, and operational risk equivalent amount:

(1) Market risk:
Risks due to price fluctuations of asset holdings, where the risk equivalent amount is calculated using a standard method or internal model based method.

(2) Counterparty risk:
The risk of losses arising from the other party to a transaction not performing its obligations (i.e., a credit equivalent amount multiplied by risk weighting).

(3) Operational risk:
Risks in daily operations (e.g., clerical errors), the value of which is determined simply as three months of operating expenses.

The trigger levels for the capital adequacy ratio are as follows:

$$\frac{\text{Non-fixed capital}}{\text{Risk-equivalent amount}} \times 100$$

< 140 percent: must report
< 120 percent: business improvement order
< 100 percent: business suspension order

Source: JFSA.

Accounting and audit requirements

43. The FIEA permits FIBOs to use several different accounting standards in their consolidated financial statements, but regulatory reporting is based on the Japanese Generally Accepted Accounting Principles (JGAAP). Consolidated financial statements can be prepared using JGAAP, International Financial Reporting Standards (IFRS) or United States GAAP (USGAAP). For example, Nomura's consolidated accounts are prepared in USGAAP, whereas Daiwa uses JGAAP. For listed companies, the transition to IFRS is ongoing.[19] For solo accounting and regulatory reporting, all FIBOs must use JGAAP.

44. External financial audit requirements are based on the company's size or status as a public issuer of securities rather than the financial instruments business it is registered for. Companies issuing securities listed on a financial instruments exchange and large companies (equity more than JPY 500 million or debt more than JPY 20 billion) require an audit certification of their consolidated financial statements or financial statements by a certified public accountant (CPA) or audit firm.[20] Further, listed companies must receive audit certification of internal control reports that assess the efficiency of internal controls related to financial reports. In addition, the Supervisory Guidelines note that it is desirable to ensure effective use of external audits by accounting auditors and others, as well as internal audits by FIBOs themselves.

45. A FIBO's compliance with the client asset segregation and management requirement is subject to a specific audit requirement. A CPA or an audit firm must conduct such audit periodically, but at least once a year. The audit must be conducted in accordance with the rules established by the JSDA. In July 2016, the JSDA published its revised rules on the appropriate implementation of the asset segregation requirement to unify the external audit process. The implementation deadline for the revised rules was March 2017.

Consolidated supervision

46. Special FIBOs are subject to consolidated supervision covering the FIBO itself and its subsidiaries (downstream consolidation). They must submit a consolidated business report, which describes the group's state of business and assets, to the JFSA within three months after the end of each business year. They must also comply with consolidated capital adequacy requirements. The JFSA may take supervisory action, including suspending all or part of the business activities of such groups for up to three months based on the consolidated capital adequacy ratios. It can also order

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[19] This is highlighted by the information published by JPX, according to which the combined market capitalization of listed companies that have adopted IFRS, those that have decided to adopt IFRS and those planning to adopt IFRS was 29 percent of the entire listed market capitalization as of June 30, 2016.

[20] At the moment, these requirements have led to approximately 200 of the 286 firms engaged in Type I financial instruments business being subject to a financial audit requirement. According to the JFSA, the fact that the majority of FIBOs registered for Type I financial instruments business are in practice subject to a financial audit requirement as listed or large companies justifies not applying the requirement systematically to all FIBOs or even the FIBOs registered for Type I financial instruments business.

the group subsidiaries or other related entities to submit reports and other materials and has the power to conduct onsite-inspections in them.[21]

47. Currently only five out of the 21 Special FIBOs are required to prepare consolidated financial statements and capital adequacy calculations at the subgroup level; the others do not have subsidiaries. The firms covered by this requirement are the main securities subsidiaries of the megabanks (SMBC Nikko Securities Inc., Mitsubishi UFJ Morgan Stanley Securities Co., Ltd., and Mizuho Securities Co., Ltd.) as well as two other securities firms (SBI Securities Co,. Ltd and Rakuten Securities, Inc.).

48. In certain cases, the parent company of a Special FIBO—the highest designated parent company—can also be subjected to supervision. This applies if:

- The parent company does the management and administration of the Special FIBO on a regular basis; or the parent company or its subsidiary lends funds to, guarantees obligations for, or provides other similar assistance with fund procurement to the Special FIBO for the purpose of its business operations, and it is found that the suspension of such assistance would be likely to substantially compromise the sound and appropriate operation of the business of the Special FIBO; and
- The JFSA finds that ensuring the sound and appropriate operation of the group's business is particularly necessary in the public interest or for the protection of investors.

49. Only Daiwa Securities Group, Inc. and Nomura Holdings, Inc. have been identified as highest designated parent companies and consolidated supervision therefore applies to the entire group. This means that capital adequacy requirements are applied to the designated parent company group. These groups have the choice of applying the Japanese capital adequacy framework or requirements aligned with Basel III and have opted for the latter. Because of the application of the Basel III framework, the groups are also required to calculate a consolidated liquidity coverage ratio and to have a group-wide system for liquidity risk management. They are also subject to the Basel III leverage ratio requirement.

50. The JFSA designated Nomura and Daiwa as D-SIBs in December 2015. This means that they became subject to a 0.5 percent surcharge in addition to their Basel III capital adequacy ratio.[22] The additional capital required by the surcharge must be in place by March 2019. The two groups' capital adequacy is currently significantly above the required minimum, including the surcharge.

[21] The powers to require reports and other materials and to conduct inspections, however, also apply in relation to the subsidiaries, holding companies and major shareholders of any securities firm, independent of whether they qualify as Special FIBOs.

[22] The surcharge is subject to an annual review but has so far been maintained at 0.5 percent.

Conclusions and recommendations

51. While the Japanese prudential requirements for securities firms address the risks arising from the most systemically important firms in an internationally comparable manner, the requirements for other firms have several atypical features. These relate to several aspects of the framework, including capital adequacy requirements, scope of financial audits, and group-wide supervision.

- While the ability to hold client assets plays a role in some jurisdictions when determining the capital adequacy requirements, many jurisdictions apply risk-based capital adequacy requirements also to other types of business than that equivalent to Type I financial instruments business. In addition, some apply a capital adequacy requirement to investment advisors that in some jurisdictions can also provide investment management services. This is often done by applying a simple operational risk charge intended to ensure that the firm has enough capital to ensure that it can be wound up within a reasonable period of time (typically three months).

- Type II financial instruments business is a Japanese peculiarity, which makes international comparisons difficult. According to the JFSA, firms currently registered solely for this business focus on the distribution of a very limited range of financial instruments, but the FIEA also permits certain other activities, including trading on own account. However, expansion of business to other activities than those currently undertaken would require amendments to the firms' registration. JFSA and Local Finance Bureaus should therefore be in a position to assess any risks emerging from the expansion of this business.

- In other jurisdictions, the requirement to audit the financial statements generally applies to all (prudentially) supervised entities. Analogy can be sought from the Basel Core Principles that require a financial audit to be conducted for all banks. The authorities justify the lack of a financial audit requirement by the fact that most securities firms registered for Type I financial instruments business are subject to financial audit as listed companies or as large companies under the Companies Act. In addition, the authorities emphasize that all firms registered for Type I business are subject to an audit of compliance with the client asset segregation requirement. However, almost 1/3 of the FIBOs registered for Type I financial instruments business are not subject to a financial audit requirement. Further, the objectives of the financial audit and client asset audit are different. Finally, it is difficult to find support for the authorities' views from international standards or peer countries.

- The requirement to prepare consolidated financial statements and determine a consolidated capital adequacy ratio applies only above a certain asset value threshold (JPY 1 trillion). At the same time, the JFSA has broad powers to ask for information from and conduct inspections in any entity related to a securities firm. The JFSA therefore appears to have the ability to assess risks arising from other group entities even in the case of smaller securities firms. Nevertheless, having such a dual system is uncommon and, if the group activities of below threshold firms are not specifically monitored with the objective of risk identification, any emerging risks may remain undetected.

52. In summary, the Japanese authorities appear to have developed a prudential regulatory framework that responded to the needs of the market at the time of its creation. Some aspects of it are not common in other jurisdictions and make judging the system particularly challenging. International standards for securities firms provide little guidance. It is evident that the framework was carefully thought through at the point of its creation.

53. However, markets are changing and the underlying rationale for the current framework risks becoming less appropriate. This opens up the possibility for new risks emerging, if certain rules are taken for granted and not regularly reassessed for continued robustness. At the same time, frameworks in other countries have been subject to continuous changes.

54. Therefore, at least within the medium term (3–5 years) the authorities should review the prudential regulatory framework for all securities firms. Such review should ensure that the framework appropriately addresses the financial stability and investor protection risks, striving towards the developing global best practice. The relatively long timeline for this recommendation recognizes the limited financial stability risks that the current framework seems to create.

B. Organizational Requirements

Risk management and control functions

55. The FIEA includes general requirements for securities firms' control systems that are further specified in the JFSA's Supervisory Guidelines. The FIEA requires a FIBO to establish an operational control system for the fair and appropriate performance of its financial instruments business. Supervisory Guidelines require the CEO and board of directors to be fully aware of the importance of risk management and emphasize that risk management should be a priority in the overall business strategy and not a mere compliance issue.

56. Supervisory Guidelines also require FIBOs to strictly comply with laws and business rules and pursue sound and suitable management. The board of directors of a FIBO is required to assume leadership to establish a policy for implementing compliance and ensure full compliance. A FIBO is expected to establish a system for ensuring appropriate communications and reporting of compliance-related information among the division in charge of sales, the division/manager in charge of compliance and the management team. A FIBO must also conduct an evaluation of internal controls.[23]

57. The JFSA and SESC have increasingly focused on supervising firms' controls. They assess overall business management via daily supervisory activities including follow-up on business improvement reports, receipt of notifications regarding financial product incidents and other situations. In supervising securities firms' internal management and risk management, the JFSA and

[23] Supervisory Guidelines require such evaluation to be conducted by the CEO, the Board of Directors, internal auditors and, if applicable, external auditors.

SESC aim at identifying the firms' risks and assessing their risk management framework through offsite monitoring and related hearings.

Outsourcing

58. The regulatory framework distinguishes between outsourcing of regulated and unregulated activities. When a FIBO outsources its regulated activities to a third party, the service provider must generally be registered as a FIBO. However, a FIBO engaged in investment management business may also outsource investment management to a firm conducting equivalent business in a foreign country. In addition, unregulated activities may be outsourced to any third party. In all cases, the FIBO must take the responsibility for maintaining sound risk management of the outsourced activities.

59. The JFSA's Supervisory Guidelines emphasize the importance of appropriate policies, procedures and controls when outsourcing administrative processes. These include whether the FIBO has a policy and procedures for selecting the business operations to be outsourced and the relevant service providers and whether it has developed a control system that enables sufficient risk management of the outsourced business operations. The Guidelines also emphasize the need to ensure that the FIBO continues to fulfill its obligations to the supervisory authorities, such as undergoing inspections and submitting reports.

60. In practice, many Japanese FIBOs outsource some of their activities. According to the JFSA, a number of FIBOs engaged in Type I financial instruments business outsource administrative tasks and systems, such as IT system development and maintenance, to third parties. Some FIBOs also outsource investment management of foreign securities to overseas investment advisors or managers.

61. The authorities supervise compliance with the outsourcing requirements primarily through offsite monitoring. When they identify a supervisory concern, they keep track of the improvements made by holding hearings with the FIBO or service provider and, when necessary, requiring them to submit reports.

Conclusions

62. The organizational requirements for securities firms comply with the international standards. The authorities' supervisory activities are increasingly focusing on the sufficiency of firms' control environment in ensuring compliance with the relevant requirements.

C. Segregation and Custody of Client Assets

63. In principle, only FIBOs registered for Type I financial instruments business are permitted to hold client assets. This is because they are the only FIBOs that can provide so called securities management services where the FIBO receives deposits of money or securities from customers in connection with the services it provides (e.g., brokerage and corporate finance

services). FIBOs registered only for IAAB are not permitted to hold client assets. The same applies to FIBOs registered only for investment management business, except that the FIEA permits them to hold client assets temporarily in cases where they conduct transactions on behalf of their investment management customers and the deposit of securities or money is necessary for the settlement of the transactions.[24]

64. The FIEA includes detailed requirements on the manner the clients' securities have to be segregated. Article 43-2 of the FIEA includes the basic rule requiring a FIBO to manage customers' securities separately from its own assets. This segregation requirement covers both securities that the customer is buying or selling and those that have been provided as collateral for derivatives trading. Exceptions are provided for securities that the FIBO may furnish as collateral or lend to another person pursuant to a written consent of the customer. Such consent can in certain cases cover a predetermined scope of securities. If that is not specifically permitted, the consent must be provided for each occasion. The various ways to ensure appropriate segregation of client assets are specified in Article 136 of the Cabinet Office Ordinance of Financial Instruments Business, etc. These include engaging a third party to take custody of client assets. In that case the third party is subject to the same segregation requirements as the FIBO itself.

65. Similar detailed requirements apply to the handling of client money. A securities firm must establish a trust with a trust company in Japan for the purpose of managing the amount of money to be refunded to the customer if the firm discontinues its financial instruments business or otherwise ceases to operate in such business. Similar to securities, the requirement covers money related to customers' securities trading and that given as collateral for derivatives trading. In addition, if the securities firm has received the client's consent and rehypothecates the customer's securities, it must make a deposit of equivalent value to the trust.

66. The JFSA, SESC and Local Finance Bureaus supervise securities firms' compliance with the asset segregation requirements. FIBOs engaged in Type I financial instruments business are required to submit reports on the client assets they hold. In supervision, the main focus is on verifying whether the firm's board of directors recognizes the importance of segregated custody of client assets and makes use of relevant information by, for example, receiving status reports on a periodic or as-needed basis. Also, one registration criterion for FIBOs engaged in Type I financial instruments business and investment management business is whether they have sound risk controls that allow for rigorous management of client assets.

Conclusions and recommendations

67. The limited review of the client asset segregation rules in Japan did not reveal any fundamental gaps compared to international standards. In the case of investment management, the ability of the firm to hold client assets without segregating them during the settlement period creates a risk in case the firm would fail during that time period. In addition, the asset segregation rules are covered by multiple laws, Cabinet Orders and Cabinet Office Ordinances. Therefore, it has

[24] According to the JFSA, this possibility is however seldom used in practice.

not been possible to fully ascertain whether any underlying legal deficiencies may exist in such a complex framework or arise from other relevant legislation.

68. In addition, any legal framework cannot by itself eliminate the possibility of misappropriation of client assets or operational errors leading to a shortfall. It is therefore essential that compliance with these requirements be subject to robust supervision. In the case of Japan, the need is even stronger than in some other countries, given the emphasis put on this requirement in establishing the other requirements applicable to securities firms (e.g., capital requirements, see above).

69. In light of the above, it is recommended that the authorities enhance supervision of compliance with the client asset segregation requirement. In addition to the authorities' own measures, this can be supported by, for example, external auditors reviewing firms' compliance with the segregation requirement more often than annually. Surprise examinations by authorities or surprise audits by external auditors may also be useful to ensure ongoing compliance and maintenance of robust processes.

D. Technological Developments

70. JFSA's strategy acknowledges the impact technological developments are having on financial markets. The JFSA's Strategic Directions and Priorities 2016-2017 specifically referred to FinTech, cyber security and algorithmic trading and noted that the JFSA would consider appropriate regulatory options to deal with algorithmic trading in Japan, while monitoring progress in other jurisdictions. In 2016, the share of orders placed through the TSE's co-location area amounted to around 70 percent and that of transactions executed reached 40–50 percent.

71. Authorities have since taken measures to address the issue. In December 2016, the Financial System Council proposed to introduce a new regulatory requirement for high-speed trading, including a registration framework that would allow authorities to monitor the high-speed traders' trading strategies and trades. In March 2017, the JFSA submitted a bill proposing a regulatory framework for high-speed traders. The bill covers the following measures:

- Organizational/system requirements, including risk controls
  - Proper management and operation of trading systems
  - Appropriate organizational arrangements and capital requirements.
- Notification and provision of information
  - Notification of engagement in high-speed trading to the JFSA or the relevant Local Finance Bureau
  - Provision of a description of trading strategies to the JFSA or the relevant Local Finance Bureau

  - Maintaining trading records.
- Other measures
  - Submission of business reports to the authority.

Conclusion

72. **Given the risks high-speed trading can cause to market fairness and financial stability, the JFSA is to be commended on taking action on this matter.** As noted in the Financial System Council's report, it is necessary to ensure that the specifics of the requirements and measures can be flexibly adapted in light of future developments in other major financial markets.

SUPERVISION

A. Organization and Resources

JFSA, SESC, and Local Finance Bureaus

73. **Within the JFSA, the primary responsibility for the supervision of securities firms lies with the Supervisory Bureau**. The Supervisory Bureau (in cooperation with the SESC) conducts offsite monitoring of securities firms falling under its direct responsibility as well as guides the activities of the Local Finance Bureaus supervising the smaller securities firms. In addition, the Supervisory Bureau, in cooperation with the SESC, collects and analyzes the reports provided by the securities firms that it is responsible for, while the rest of the reporting goes to the Local Finance Bureaus. Inspections are undertaken by both the SESC and Local Finance Bureaus. The JFSA's Inspection Bureau's involvement is very limited, given the SESC's specific role in inspections of securities firms.

74. **The supervision of the two major independent groups and the megabanks' securities subsidiaries is undertaken differently from that of the other securities firms.** The supervisory teams for the independent groups are composed of staff from the JFSA's Supervisory and Inspection Bureaus and the SESC that work in an integrated manner without a strict separation of tasks into offsite monitoring and inspections. The total number of staff exclusively involved in Nomura and Daiwa supervision is 25 (three in the JFSA Supervisory Bureau, 14 in the JFSA Inspection Bureau and eight at the SESC). In the case of the megabank subsidiaries, the five staff members from the Inspection Bureau cover risk management and the dedicated team includes three staff members from the Supervisory Bureau and seven from the SESC. The employer of the staff member is however a formality in both cases, and there is no strict separation of roles, particularly under the new supervisory approach where fewer onsite inspections are conducted.

75. **The overall staff resources allocated to securities firm supervision are concentrated on the Local Finance Bureaus and SESC.** The JFSA's Supervisory Bureau has 44 persons devoted to securities firm supervision, whereas at the SESC the number of relevant staff amounts to 129 and in

the Local Finance Bureaus to 232. In addition, the resources include the above mentioned JFSA Inspection Bureau team engaged in the supervision of the two major groups.

76. The authorities are conscious of the importance of securing sufficient continuity and expertise in the supervision of the major firms and are aiming to achieve it despite the traditional approach of rotating staff within the government authorities. For example, the supervisory teams for these firms are typically composed of staff that has already been involved in the supervision of other securities firms. At the same time, the rotation policy enhances the senior management's breadth of expertise, which was seen positively by market participants.

Self-regulatory organizations

77. SROs' supervisory resources complement those of the government authorities. The JSDA's Inspection Headquarters engages 57 staff, whereas JPX-R has a total of 38 staff conducting onsite and offsite inspections of trading participants. The smaller SROs have a total of 88 supervisory staff (Type II Financial Instruments Firms Association 8; FFAJ 22; JITA 38; and JIAA 20).

Conclusions and recommendations

78. The overall number of staff allocated to securities firm supervision appears sufficient. The relatively well resourced SROs provide additional support to the government authorities.

79. Given the importance of robust supervision of the major firms, the authorities should continue to ensure that the relevant teams have access to sufficient number of experienced staff. The authorities are very conscious of the importance of this and take it into account in choosing the team members.

B. Registration and Authorization of New Firms

Statutory registration requirements

80. A person seeking registration as a FIBO has to submit an application to the Local Finance Bureau of the region where the firm is located (or individual resides). Registration can be sought for any number of the business categories permitted for a FIBO (i.e., Type I/Type II financial instruments business, IAAB, investment management business).[25] The written application must specify the actual activities within each business category that the applicant plans to undertake.

81. Registration must be refused if certain criteria are not met. These criteria include requirements relating to personnel structure and execution of business operations, which apply to all types of FIBOs. Applicants seeking registration for Type I or Type II financial instruments business or investment management business must meet the initial capital requirements described above

[25] Investment management business to qualified investors is subject to a notification requirement.

and have an office in Japan. Applicants for Type I financial instruments business and investment management business are subject to the requirement to have net assets equaling their initial capital requirement (see paragraph 35). Applicants for Type I financial instruments business must also have a capital adequacy ratio of at least 120 percent (see paragraph 37).

82. Operating a Proprietary Trading System (PTS) requires both registration for Type I financial instruments business and a separate authorization for operating the system. The authorization is subject to having at least JPY 300 million of capital. The applicant's price formation method, settlement method, business plan and business methods must ensure that public interest and investor protection are maintained. JFSA's Supervisory Guidelines include further authorization criteria (e.g., internal controls, disclosure of price information, reporting of transaction volume, etc.).

83. Registration requirements also apply to branches of foreign securities firms and financial institutions seeking to engage in financial instruments business. Branches of foreign securities firms are subject to the same registration requirements as Japanese FIBOs and get the full FIBO status. The only difference in their registration criteria is that they must provide information on the amount of stated capital or the total amount of contributions and the amount of brought-in capital (i.e., assets corresponding to the stated capital that is brought into Japan). They must also appoint a representative based in Japan. A financial institution seeking to perform the limited securities business permitted to entities other than securities firms (see above) is subject to similar registration requirements as an applicant for a FIBO registration.

84. The Local Finance Bureau processing the application must follow the FIEA and the JFSA's Supervisory Guidelines to verify compliance with the registration criteria. The applicant and its staff are required to appear and answer questions at the Local Finance Bureau. The staff member reviewing the application prepares an internal report and a recommendation for registration to his/her superiors at the Local Finance Bureau. If the recommendation is to register the applicant, a copy of the recommendation (together with an executive summary of the application) is sent to the JFSA. Notification is given to the applicant when the JFSA has decided to grant the registration. The date of registration and the registration number are disclosed in the financial instruments business register. In the calendar year 2016, a total of 17 new registrations were granted (7 for Type I financial instruments business, 1 for Type II financial instruments business, 1 for IAAB and 8 for investment management business).

85. Refusal of registration is subject to due process requirements, but in practice refusals seldom happen. Before seeking to refuse a registration or authorization (or a change relating to a previous registration), the Local Finance Bureau must notify the applicant and conduct a hearing. Applicants must be notified of any refusals or attachment of conditions in writing. The notification must include the grounds for refusal and state that the applicant is entitled to make a request to the JFSA Commissioner for an examination and file a claim against the government to rescind the decision. The Local Finance Bureaus have not refused registrations for any of the officially received applications during the past five years. According to the JFSA, in practice the prospective applicants discuss with the Local Finance Bureau staff before submitting an application, which effectively eliminates applicants that would need to be rejected.

JPX trading participant admission process

86. JPX trading participants are subject to an admission process. JPX-R conducts the examination based on documents, hearings, onsite inspections of internal management systems at the applicant's headquarters and branch offices, and interviews with senior executives. The qualification criteria for FIBOs include:

- Financial criteria
  - Capital of at least JPY 300 million;
  - Net assets of at least JPY 500 million and an amount greater than capital; and
  - Capital adequacy ratio exceeding 200 percent.
- Operational criteria
  - Sound management structure;
  - Order placement, execution, and clearing and settlement systems that contribute to fair and smooth trading; and
  - Appropriate internal management system (compliance with laws and regulations, risk management, development of rules, etc.).

Conclusions

87. The application and registration/authorization process for new FIBOs is generally in line with the international standards. Since the mission did not meet with the Local Finance Bureaus, the discussions did not cover the practical application of the framework, but focused on the guidance prepared by the JFSA.

C. Supervisory Approach

JFSA and SESC

88. The JFSA and SESC are currently implementing their new supervisory approaches that put increased emphasis on offsite monitoring. This is driven by the increasing number of supervised entities and the increased diversity and complexity of products and transactions. The new approach will shift focus from onsite inspections that mainly examined financial institutions' compliance with minimum requirements on the basis of inspection manuals to a new monitoring framework that integrates onsite and offsite monitoring. The basic supervisory approach is made public by disclosing the JFSA's Supervisory Guidelines. The SESC, for its part, released its first annual

statement on monitoring priorities for securities business for July 2016–June 2017, setting forth its general approach to monitoring securities firms.[26]

89. The new process will be based on an offsite assessment of the viability of the firm's business model, the effectiveness of its governance, and the appropriateness of its risk management in light of its business model. The approach will evaluate the effectiveness of the firm's three lines of defense: front-office; risk management and compliance; and internal audit functions. The assessment will take into consideration the individual characteristics of each securities firm, including its business model and scale of operations. The JFSA and SESC will use the results of this offsite monitoring, together with risk-based analysis, to determine which securities firms will be subject to onsite monitoring. In carrying out onsite monitoring of a securities firm, the JFSA and SESC will conduct in-depth analyses of the firm's products and transaction strategies to assess its compliance with relevant laws, regulations, and market rules. When these analyses identify a problem, the SESC will go further to identify the root causes of the problem. In such cases, the SESC would launch a formal onsite inspection.

90. An important source of information for the offsite monitoring of all securities firms is the firm's annual business report, whereas firms registered for Type I financial instruments business are also subject to other reporting requirements. All FIBOs are required to submit the business report to the JFSA or the relevant Local Finance Bureau within three months of the end of the business year. The other reporting requirements cover, among others, the capital adequacy ratio and liquidity risk. Reporting also occurs on a consolidated basis for groups that have the highest designated parent company. The reports are submitted electronically. The Local Finance Bureaus process the reports in accordance with the JFSA guidance, cooperating with the relevant JFSA divisions, as needed.

91. Offsite monitoring is also conducted through dialogue and meetings (hearings). As a result, the borderline between offsite and onsite monitoring is not clear cut. Informal dialogue is particularly important in the case of the major securities groups. The key objective of such dialogue is to ensure that the groups' business strategy and risk management can flexibly respond to the changing market and economic environment. The authorities also engage in a dialogue with the other securities firms about the risks and challenges the firms face, so that they can ensure that the firms have a sound control system. The JFSA and SESC also conduct interviews with the foreign-owned securities firms, with attention to their global business model. For securities firms engaged only in Type II financial instruments business or IAAB, the JFSA and SESC work closely together to analyze and assess relevant data and conduct risk-based monitoring. In the case of firms engaged in investment management business, the JFSA and SESC work closely together to monitor that proper governance is in place.

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[26] This replaced the annual Securities Inspection Policy documents issued previously. In its monitoring of securities business, the SESC had traditionally focused on reviewing a firm's control environment for legal/regulatory compliance, risk management, and financial soundness, as well as its internal control environment. These reviews were typically conducted through onsite inspections.

92. The offsite monitoring information will be used to determine a risk profile for each securities firm, on the basis of which onsite inspection priorities will be determined. The risk profile system follows the model used for the largest banks, but is still in the process of being implemented. It is already well established in the supervision of the two largest securities groups and the securities subsidiaries of the megabanks, where the risk profiles are used to determine resource allocation. The risk profiles take into account information received through reports, other offsite monitoring, and a yearly questionnaire sent to the firms.[27] They also take into account the controls in place. The system is gradually being extended to apply also to other securities firms, with the objective of ultimately covering all firms engaged in Type I financial instruments business independent of whether the firms are supervised by the JFSA or the Local Finance Bureaus. The latter conduct the work under the guidance of the JFSA and SESC. The risk profiles are updated on a quarterly basis and reported to the management.

93. As part of the introduction of the new supervisory approach, the SESC and Local Finance Bureaus are in the process of enhancing their cooperation. To ensure a uniform approach to monitoring, the SESC supports the individual Local Finance Bureaus in planning and implementing offsite monitoring. If offsite monitoring suggests that a FIBO's operational risk is significant or a FIBO falls under the jurisdiction of multiple bureaus, the SESC conducts onsite monitoring of such FIBO alone or jointly with the relevant Local Finance Bureau/Bureaus. The SESC also works closely with the SROs, including by sharing perspectives on problems to raise the efficiency of the monitoring program and ensure fairness and transparency in the markets. The SESC is also considering the best balance between monitoring by the SESC and examinations by SROs and how best to facilitate cooperation between the SESC and the SROs.

Onsite inspections

94. The primary responsibility for onsite inspections lies with the SESC. In the past, its inspections of securities firms and financial institutions conducting securities business focused on possible violations of laws and regulations and the firms' financial soundness. Under the new supervisory approach, the intention is to conduct onsite inspections on the basis of risks identified through offsite monitoring. Onsite inspections will be used in a more limited manner than in the past, but other activities (such as hearings) can also take place onsite. An onsite inspection finishes with an inspection completion notice, in which the inspected firm can be urged to make certain improvements. If serious legal or regulatory violations or governance deficiencies are found, the SESC recommends that the Prime Minister and the JFSA Commissioner take administrative action against the firm. Additionally, problems found in the inspection, whether or not they lead to administrative actions, are shared with the JFSA.

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[27] A questionnaire is not sent to Nomura and Daiwa.

95. Inspection priorities in the past three years have included:

- Major securities groups: internal controls, management controls, and risk management system from a forward-looking perspective;
- Type I financial instruments business: corporate client information control system, financial soundness, countermeasures to prevent money laundering, risk management in response to FX market volatility;
- Type II financial instruments business: compliance, risk management and suitability of solicitation for overseas funds; and
- Investment management business: due diligence, suitability of solicitation, and conflicts of interest.

96. The number of inspections the SESC completed in the past three financial years is presented in Table 4. The table also includes information on the number of recommendations for administrative actions the SESC gave to the JFSA based on these inspections. According to the JFSA and SESC, in practice the JFSA always follows the recommendations of the SESC and takes the proposed enforcement actions.

97. The SESC has also set certain industry-wide and thematic monitoring priorities for the current fiscal year. It intends to review the effectiveness of governance, IT systems, risk management, internal audit, and legal/regulatory compliance at securities firms across all business categories, taking into account each firm's scale and business model. The SESC will also monitor securities firms with a particular focus on their progress with regard to fiduciary duty, cybersecurity, and surveillance of trading using direct market access and high-speed trading.

International cooperation

98. International supervisory cooperation takes place through hosting a supervisory college, participating in supervisory colleges hosted by foreign authorities and ongoing contacts. The college hosted by the JFSA and SESC typically meets once a year. In the interim, there is frequent ongoing exchange of information and views between the college members. These include teleconferences on actual topics. In addition, the JFSA Supervisory Bureau and SESC participate in several supervisory colleges for large, globally active banks that have securities subsidiaries in Japan.

99. The international cooperation can utilize the IOSCO Multilateral Memorandum of Understanding (MMoU). In the past three years, the JFSA has made nine requests under the MMoU in relation to inspections of FIBOs.

Table 4. Japan: Number of SESC Inspections and Recommendations to the JFSA

	04/2013-03/2014		04/2014-03/2015		04/2015-03/2016	
Category	Inspections Completed	Recom-mendations Made	Inspections Completed	Recom-mendations Made	Inspections Completed	Recom-mendations Made[1]
FIBOs	230	18	232	15	128	18
Type I FIBOs	63	3	86	3	58	12
Type II FIBOs	81	6	94	5	33	1
IAAB	40	5	38	6	31	6
Investment Management Business	46	4	14	1	6	0

Source: SESC.

[1] Some firms are registered in multiple categories so the total volume for individual categories and the number of recommendations do not match.

Other monitoring and analytical tools

100. In 2015, the JFSA established the Macroprudential Policy Office to analyze the financial market and macro-economic environment. The Office analyzes, among other issues, the domestic and overseas market trends, fund inflows and outflows, and macroeconomic indicators. Relevant information and analysis is shared with the other divisions as a basis for their firm level monitoring. For example, the supervisory teams for the two major securities groups use this information as background in their daily interactions with the supervised firms.

101. In the current fiscal year, the JFSA is extending firm level stress testing to the largest securities groups. The same bottom-up scenarios (determined by the JFSA) are used as for the stress testing of banks. The process was initiated at the beginning of the fiscal year, so it is still in early stages.

Self-regulatory organizations

Japan Securities Dealers Association

102. JSDA establishes an inspection plan, the primary objective of which is investor protection, at the beginning of every fiscal year. It conducts inspections to check the establishment of internal administration systems; compliance with laws, regulations, JSDA rules and internal rules; segregation of customer assets; and sales practices. JSDA aims at adapting its

inspection methods, focuses and inspection items to each member's scope of business, customer base, risk exposure, etc. It has four inspection types:

- General inspection: an overall inspection of compliance with laws and regulations, development of internal administration systems, and financial status.

- Special inspection: an inspection conducted when necessary concerning specific items.

- Follow-up inspection: an inspection of a member that had been required to submit an improvement report based on JSDA's own or a regulator's inspection to verify implementation of the previous inspection's recommendations.

- Inspection of new members: An inspection of a member that has been a member for less than six months, to confirm whether its operations are being conducted properly.

103. JSDA's inspections can be conducted either onsite or offsite and firms to be inspected are selected based on a number of criteria. Normally inspections are conducted onsite by visiting the member's head office, branch offices and sales offices. An inspection can also be conducted offsite, if an onsite inspection is not deemed necessary based on the scope of business and size of the firm. The JSDA considers several factors in selecting the firms to be inspected, such as:

- Status of capital adequacy: regular members whose capital adequacy ratio has fallen below 200 percent or those whose ratio still exceeds that threshold but is declining rapidly;

- Various information: members whose actual business operations, financial property, officers and large shareholders need to be verified in light of the information collected through offsite monitoring or those that receive many complaints from investors or frequently cause financial instrument incidents;

- Past inspection records: members that have been subject to disciplinary actions as a result of the JSDA's or regulator's inspections or those that have had deficiencies in their internal administration system identified in past inspections; and

- Nature of business and customer base: members dealing mainly with high-risk financial products or with a strong focus on retail business.

104. JSDA's inspections have a clear investor protection focus, even though some elements are also relevant for financial stability. JSDA typically reviews compliance with the suitability principles and sales practices in connection with the sale of complex products and switching of investment trusts. However, it also verifies the status of segregation of customer assets and calculation of capital adequacy ratio and conducts an overarching review of the status of development and strengthening of the overall internal administration system. During the fiscal years

2013–15, the inspections identified a number of deficiencies in the inspected firms, including violations of laws and regulations, JSDA's rules, and deficiencies in internal administration systems.[28]

105. JSDA also conducts offsite monitoring. The JSDA's offsite monitoring focuses on members suffering financial deterioration, members on which the JSDA has information that raises concerns, and members subjected to significant disciplinary actions. It shares such information with the JFSA, SESC and Local Finance Bureaus with the objective of jointly dealing with the situation.

JPX-R

106. JPX-R conducts inspections of trading participants with the primary objective of ensuring market fairness. The objective of the inspections is to assess trading participants' compliance with laws, regulations, and exchange rules as well as their business operations and financial soundness. There are several types of inspections which are conducted either onsite or through document-based inspections.

- General inspection: JPX-R inspects trading participants following a risk-based approach, conducting joint onsite inspections with the JSDA and other securities exchanges.
- Follow-up inspection: conducted as needed within one year after a previous inspection to confirm whether the trading participant has remedied the deficiencies identified in the previous inspection.
- Special inspection: conducted using a variety of offsite information with a focus on specific items.

107. JPX-R's risk-based approach to determining trading participants for inspection takes into account various factors. They include the results of recent JPX-R and SESC inspections; the financial condition of the trading participants assessed through offsite monitoring; reports provided by trading participants; and information provided by other JPX departments. The large majority of JPX-R inspections is currently conducted jointly with the JSDA. The fiscal year 2016 onsite inspections lasted on average 11 days and engaged 7 inspectors.

108. Based on the market environment, JPX-R has identified the following topics for priority inspection for the financial year 2016–17:

- Order management systems;
- IT system risk management;
- Underwriting systems for IPOs;

[28] During these three years, 71 regular and 29 special members were notified of breaches of laws and regulations and 68 regular and 7 special members of deficiencies in internal administration systems. Some members may have been subject to several notifications.

- Systems for management of corporate information; and
- Credit risk management concerning customer positions for margin trading.

109. The JPX-R Trading Participants Examination and Inspection Department cooperates with several regulators to exchange information related to inspections. This includes regular reports to the SESC, including inspection plans and reports on the results of each inspection. Periodic and ad hoc meetings are organized between the JFSA, SESC, Local Finance Bureaus, JPX-R and JSDA to exchange inspection related information. In addition, the regulators and SROs communicate frequently by phone and email.

110. JSDA and JPX-R conduct joint inspections of JSDA members that are also trading participants at JPX. The number of inspections they conducted in fiscal years 2013-2015 is set out in Table 5.

Table 5. Japan: Number of JSDA Inspections and Joint JSDA and JPX-R Inspections

Type of Business	FY2013	FY2014	FY2015
JSDA regular members (securities firms)	87	84	80
Joint inspections with JPX-R	28	31	30
JSDA's own inspections	59	53	50
Special members	53	48	44

Source: JSDA.

Conclusions and recommendations

111. The adoption of the new supervisory approach by the JFSA and SESC is well justified. The approach, if applied in a sufficiently consistent manner across the authorities, enables the JFSA and SESC to better focus on emerging risks and how firms' governance and controls address those risks. At the same time, the Local Finance Bureaus have an important role in supervising the smaller firms. The SROs' supervisory activities help ensure that investor protection and market fairness are maintained. However, it may still take a while for the staff to fully adjust to the new approach, including in terms of accumulating sufficient expertise in applying it. Finally, offsite monitoring and hearings on their own are unlikely to be sufficient in identifying risks and control deficiencies, in particular in firms subject to less intensive offsite monitoring.

112. As a result, it is important to address the transitional challenges and carefully balance offsite and onsite activities. The JFSA and SESC should continue to provide sufficient training and guidance to the Local Finance Bureaus, particularly during the transitional stage. In addition, it is

important that the authorities continue to use onsite inspections as an important complementary tool to more intensive offsite monitoring after the full implementation of the new supervisory approach.

113. International cooperation in the supervision of Japanese firms' overseas operations and foreign-owned firms' activities in Japan is very important, given the global nature of the firms' business. In particular, it is important to continue to enhance onsite monitoring of Japanese securities firms' overseas operations jointly with foreign supervisory authorities, building on the existing cooperation. Further, given the large aggregate market share of foreign-owned securities firms in Japan, it is recommended that the authorities continue to ensure sufficient cooperation with the foreign authorities supervising the parent banks of Japanese securities firms. This will help ensure continuous access to sufficient information on potential cross-border risk channels.

D. Enforcement

JFSA and SESC

114. The JFSA can take certain enforcement action against a FIBO or financial institution registered for securities business. Enforcement action is generally taken on the basis of a recommendation from the SESC. The most important tool used is a business improvement order that requires the firm to change its business methods or take other necessary measures to improve its business operations or state of assets. Such an order can be given if the JFSA finds it necessary and appropriate in the public interest or for the protection of investors. The JFSA may also rescind the registration of a FIBO or order the suspension of all or part of its business activities as an enforcement measure in cases defined in Article 52 of the FIEA. The JFSA can also issue an administrative monetary penalty in relation to insider trading, market manipulation or fraud, but not for systems and control deficiencies. JFSA considers that the current enforcement tools are sufficiently effective.

115. Enforcement actions are generally published. The SESC's recommendation to the JFSA is normally public, in which case the JFSA also publishes the final enforcement action. In deciding on the publication of its recommendations and other inspection information, the SESC considers confidentiality, transparency, fair enforcement and investor protection. Generally, the SESC publishes the following information on its website.

- Where administrative action is recommended, the SESC publishes relevant information immediately after completing the inspection. The information includes the inspected party's name and trade name, representative name, registered business type, and non-compliant activities.

- Where administrative action is not recommended, the SESC may publish relevant information but omit the inspected party's name and trade name.

- The SESC publishes a summary of actions related to inspections (overview of securities inspections) every year that summarizes problems identified in inspections and their root causes, with the aim of enhancing FIBOs' internal controls.

Self-regulatory organizations

116. Under delegation from the Board of Governors, the Self-Regulation Board of the JSDA may take disciplinary action against JSDA members. Reasons include violations of laws, regulations, JSDA articles of association and other rules. The process is initiated by an incident report that a member has to file with the JSDA immediately when it becomes aware of a violation. This means that the JSDA is informed of the SESC's inspections and the JFSA's enforcement actions by the members themselves. The disciplinary actions taken by the JSDA can include expulsion, suspension or limitation of regular membership for up to six months, imposition of a fine of up to JPY 500 million, and reprimand. If an improper gain has been generated, its amount may be added to the fine, as a result of which the total fine may exceed JPY 500 million. In determining the level of its fine, the JSDA takes the administrative fines into account to avoid double penalty. The JSDA may also give a non-public admonition or written warning.

117. JSDA has used its disciplinary powers. In fiscal years 2014-2016, the JSDA expelled one member, fined 14 members, one of which was also suspended, and reprimanded one member. The largest fines given were JPY 30 million to two firms (the same firms were also subject to JFSA's enforcement action as well as JPX-R's disciplinary measures).

118. JPX-R determines exchanges' disciplinary actions against TSE and Osaka Exchange trading participants for violations of laws and regulations. Possible actions include fines, censure, trading suspension, and limiting or canceling trading qualifications. The disciplinary actions are determined after hearing the trading participant, consultation with the disciplinary committee, which is an advisory body to the JPX-R board. TSE and Osaka Exchange take action based on the recommendations of JPX-R. The disciplinary actions are published and several actions have been taken over the past years.[29]

119. Other SROs have also taken disciplinary actions in the course of the fiscal years 2013-2015. The total number of actions taken by them is 14 (FFAJ 2 and JIIA 12). JITA and the Type II Financial Instruments Business Operators Association have not taken any disciplinary actions.

Conclusions

120. The enforcement and disciplinary framework for securities firms appears to be sufficiently effective. The JFSA and SROs have taken multiple enforcement and disciplinary actions in the course of the past few years. Their enforcement and disciplinary processes are transparent.

[29] http://www.jpx.co.jp/english/rules-participants/participants/actions/index.html.

Therefore, despite the lack of administrative monetary penalties for JFSA's use in the case of systems and controls failures, the system overall appears to be sufficiently comprehensive.

E. Failure of a Securities Firm

121. The most important measure protecting clients from the consequences of the failure of a securities firm is the requirement to segregate client assets (securities and money). As long as the segregation requirement is observed, even if a securities firm goes bankrupt, customer assets are protected from creditors' claims. If the customer assets cannot be returned on the failure of a firm, the Japan Investor Protection Fund (JIPF) provides compensation of up to JPY 10 million per customer for the missing assets. Membership in the JIPF is compulsory for all FIBOs engaged in Type I financial instruments business.

122. There are certain limitations in the JIPF's ability to compensate clients in the case of a bankruptcy. Firstly, only individual customers and corporations[30] are eligible for compensation. The government and local governments are also excluded from coverage. The client assets eligible for compensation are limited to those entrusted by customers concerning the securities or commodity derivatives related business conducted by securities firms. The following transactions handled by securities firms are not eligible for compensation by the JIPF:

- Over-the-counter financial derivatives transactions;
- Financial derivatives transactions on overseas exchanges;
- On-exchange currency transactions;
- FX transactions; and
- Transactions in financial instruments that fall under the Type II financial instruments business.

123. The compensation procedure follows certain predetermined steps. JIPF member securities firms must immediately notify JIPF in the event that their registration is revoked or they file a petition for the commencement of bankruptcy proceedings. In cases where the notifying member is unable, or highly likely to be unable, to return the money and securities entrusted by customers, JIPF issues a public notice of difficulty in payment. Customers will then submit documents requesting payment to JIPF, which checks the documents against the records of the notifying member and pays the compensation up to a maximum of JPY 10 million. JIPF then acquires the claim that was subject to compensation from the customer. The bankruptcy trustee initiates the liquidation proceedings of the notifying member in parallel with JIPF's compensation payment determination process. Customers requesting payments exceeding JPY 10 million may therefore be entitled to receive additional distributions.

[30] However, corporations that are qualified institutional investors are not eligible for compensation.

124. The balance of JIPF's investor protection fund was approximately JPY 57 billion at the end of fiscal year 2015. The amount deemed sufficient for investor protection activities is JPY 50 billion. When the balance of the investor protection fund is less than that, member securities firms must pay the levies computed based on a basic calculation amount of JPY 5 billion per year. Because the balance of the investor protection fund has been at or above the required amount, JIPF has not collected any levies since the fiscal year 2003. The last time the JIPF investor protection fund was tapped was in 2015, when the JIPF paid the total amount of approximately JPY 172 million to the 635 customers of Marudai Securities, which went bankrupt in March 2012.

Other measures to deal with a failing securities firm

125. The Deposit Insurance Act was amended in June 2013 to introduce the orderly resolution regime that can be applied also in the case of a failure of a securities firm. This framework is discussed in detail in the Technical Note on Crisis Management, Resolution and Financial Safety Nets. In principle, the new regime covers all financial institutions, including securities firms, regardless of their size and systemic importance. However, the Prime Minister can make the decision to trigger resolution only after the Financial Crisis Response Council has confirmed the existence of systemic risk. In practice this means that the new framework would likely be considered only in the case of the failure of a large securities firm.

126. Securities firms also quality for lending by the Bank of Japan (BoJ). This is possible under Article 38(1) of the Bank of Japan Act, under which the Prime Minister and the Minister of Finance may, when they find it especially necessary for the maintenance of stability of the financial system, request the BoJ to conduct the business necessary to maintain stability of the financial system, such as to provide loans to the relevant financial institution. In such cases, the BoJ may provide emergency liquidity assistance if approved by its Policy Board.

127. The authorities have also worked to enhance the resolvability of the major securities groups. Recovery and resolution planning has been discussed in a Crisis Management Group (CMG) with relevant foreign authorities. The authorities also participate in other relevant CMGs.

Conclusions

128. The Japanese legal framework includes various tools to try to address the risks arising from the failure of a securities firm. The asset segregation requirements and the establishment of an investor protection fund are important measures to protect non-professional clients from the impact of a securities firm's failure. An orderly resolution regime for banks and non-bank financial institutions has also been established, although operational details for the application of the regime to non-banks still need to be elaborated.

Annex I. Types of Financial Instruments Business Operators

Type I Financial Instruments Business (FIEA Article 28(1))	**Type II Financial Instruments Business (Article 28(2))**
1. Regarding securities with high liquidity: • Sales and purchases, market derivatives transactions, and foreign market derivatives transactions • Acting as intermediary, agent, or representative for such transactions • Acting as intermediary, agent, or representative for such transactions • Acting as intermediary for securities settlement, offering of securities, or handling of an offering or public or private placement of securities 2. OTC derivatives transactions or acting as intermediary, agent, or representative for these transactions 3. Underwriting securities 4. PTS business 5. Securities management business, etc.	1. Public or private placement of investment trust beneficiary securities and equity in collective investment schemes (so-called "self-placement") 2. For securities defined in Article 2(2) of the FIEA: • Acting as intermediary, agent, or representative for such transactions • Acting as intermediary, agent, or representative for such transactions • Acting as intermediary for securities settlement, offering of securities, or handling of an offering or public or private placement of securities 3. Market derivatives transactions or foreign market derivatives transactions not related to securities, and acting as intermediary, agent or representative for such transactions, and acting as intermediary, agent, or representative for such transactions. 4. Acts specified by Cabinet Order as corresponding to financial instruments business.
Investment Management Business (Article 28(4))	**Investment Advisory and Agency Business (Article 28(3))**
1. Entering into asset management contracts with registered investment corporations and managing money or other assets as an investment with regards to securities, etc. (investment corporation asset management business) 2. Entering into discretionary investment contracts and managing money or other assets as an investment (discretionary investment management business) 3. Managing money or other assets contributed by the right holders of the beneficiary certificates of investment trusts with regards to securities (investment trust management business) 4. Managing mainly as an investment, money or other assets contributed by the holders of trust beneficiary rights or equity in collective investment schemes with regards to securities (self-management).	1. Entering into investment advisory contracts and providing advice on investment decisions based on analyses of the values of securities or other financial instruments in accordance with these advisory contracts (investment advisory business) 2. Acting as an agent or intermediary for entering into investment advisory contracts or discretionary investment contracts.

Source: JFSA.