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INTERNATIONAL DEVELOPMENTS

Hints for Offshore Compliance Professionals From Japan's SESC 2010 Inspection Program Summary

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Japan's Securities and Exchange Surveillance Commission's (SESC) ''Basic Inspection Policy and Inspection Program for Business Year 2010 (''2010 Program''; http://www.fsa.go.jp/sesc/english/20100512/02.pdf) released earlier this year (April 2010) has recently been the subject of several public presentations by senior SESC officers seeking to alert international financial intermediaries as to the direction of inspections in Japan. The core theme of the 2010 Program is that inspections should be conducted efficiently both from the perspective of the scarce staffing resources of the SESC and from the perspective focusing on financial intermediaries that pose either potential systemic risks or significant risks to end investors. In this sense the shadow of the ''Lehman Shock'' continues to dominate financial inspections in Japan.

Priority Inspection Areas.

The 2010 Program states that the SESC's priority inspection of financial intermediaries (''FIs'') during 2010 will be conducted on the basis of perceived ''status of risk'' and the ''soundness of their financial position and appropriateness of the institution's risk management systems from the perspective of preventing them from suffering a management failure.'' This means that foreign FIs can anticipate inspections that compare (i) a firm's capital position (capital adequacy for banks and solvency margins for securities firms) and stability of operations against (ii) the perceived potential for a risk management failure.

In addition to a close examination of risk management systems in the enterprise, the 2010 Program also indicates that financial intermediaries can expect a close examination of their information technology (and IT backup) systems with a view to ensuring fairness and transparency in the operations of these firms. Thus,

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compliance functions in intermediaries should be prepared to brief inspectors on the design and functioning of IT systems using staff that are not only technically proficient, but also skilled at communicating an IT systems' reliability and redundancy.

The SESC will also continue to place emphasis on enhancing its inspections with a view to ensuring that violations of laws and regulations are identified and corrected. A core concept of SESC inspections is that FIs are expected to conduct all business operations in accordance with laws, regulations and market rules to promote an environment which encourages investor participation. As such, the SESC will continue to focus on examination of compliance with laws and regulations and has noted that many investment advisory firms and agencies were found to have violated laws or regulations in past examinations due to an insufficient awareness about legal compliance requirements among officers and employees and an inadequate internal control system. Examples of such failures include trading securities without the appropriate registration and untruthful advertisements. Training employees and ensuring that there is a sufficient level of compliance knowledge within the FI should be considered a priority.

Additional priority areas identified in the 2010 Program include: (i) the quality of anti-money laundering screening; (ii) prevention of insider trading; and (iii) preventing market (and stock price) manipulation activities by market participants.

Prior Notice of Inspections.

The long standing practice in Japan of launching financial inspections with no prior notice (and the consequent substantial disruption of the FIs' business operations) has been a complaint of the international financial community in Tokyo for many years. Apparently recognizing that in some cases such disruption can itself exacerbate the very risks that inspections are designed to identify and remedy, the 2010 Program notes that the SESC ''will introduce prior notice inspection on a case-by-case basis'' taking into account the nature of the business of the targeted firm, the priority inspection items and the efficiency of the inspection.

Thus, while financial intermediaries still need to be ready to deal with inspections upon a moment's notice, in many cases they will have some advance preparation time to ready themselves and their operational records and policies for inspection. This public (albeit limited) introduction of a prior notice policy for inspection is widely recognized among international compliance professionals as the most positive development in the 2010 Program. Anecdotal information from the Tokyo market suggests that prior notices of inspection have been focused more on larger institutions needing more lead time for the inspection and that many inspections of smaller intermediaries continue to receive no notice at all.

Review of Internal Control Systems.

The 2010 Program notes that the focus on assessing the level of risk management capability at financial intermediaries will be primarily directed at a review of the firm's ''internal control system'' (i.e., compliance resources and capabilities) not only with a view to evaluating whether compliance failures have occurred, but also by considering whether the system actually in place is sufficient and functioning to identify and manage the firm's principal sources of risk.

Notably, the 2010 Program states that beyond the adequacy and quality of such systems, inspectors will also evaluate the degree to which an FI's management team is involved in system design and understands (or can understand) the outputs of the internal control and risk management system. As a result, senior management of foreign FIs in Japan can expect significantly more ''face time'' with inspectors going forward.

Solicitation and Marketing Activities.

Another focus area of the 2010 Program is the solicitation process for investors with a primary focus on:

- solicitation only of products permitted under relevant licenses;
- the sufficiency of product ''suitability'' determinations based customer knowledge, experience and assets held;
- the adequacy of disclosure and product explanations;
- the appropriateness of advertising for financial products; and
- complaint handling procedures.

This description of the current inspection priorities accords with market information regarding actual recent examinations (particularly of securities firms).

Of particular note for hedge fund and investment fund managers is the comment in the 2010 Program that recent ''inspections of financial instruments firms that engage in the management and sale of collective investment schemes has uncovered ''many cases of serious violations of laws and regulations, such as the misappropriation of investment funds, the use of false or misleading representations and failures in segregated management.'' Distributors and managers of investment funds should understand from these comments in the 2010 Program that their behaviour is likely to be closely scrutinized during inspections in 2010.

Other Noteworthy Items.

In an unusual (and unexpected) display of openness, the SESC states in the 2010 Program that it seeks ''enhancement of an interactive dialogue with management of inspected financial instruments firms as part of the inspection process including the ''exchange of opinions'' so as to assess how the ''management team recognizes its deficiencies'' and ''is encouraged to make voluntary improvement efforts.''

Market observers confirm that in recent inspections the SESC has become far more receptive to ''give and take'' with managers and compliance professionals, and that it is now easier to have a reasonable dialogue with inspectors to explain how a firm's control systems work in practice (in particular where they do not follow a familiar model). This willingness to be convinced of the effectiveness of compliance systems through an interactive dialogue is a marked departure from the traditional Japanese ''checklist'' approach to inspections and we believe arises from the SESC's increasing sophistication and desire to focus on real world sources of financial system and financial intermediary risk. FIs are cautioned, however, to take care in such dialogues not to inadvertently make admissions of failures with specific rules or guidelines as such unintended admissions have in the past sometimes resulted in heavy sanctions.

The 2010 Program also notes that the SESC going forward will be working more closely with other regulatory (and self-regulatory) bodies both domestic and foreign, and will not only be updating existing inspection manuals, but also introducing new ones (including an inspection manual for credit rating agencies).[1]

2010 Inspections By the Numbers.

The 2010 Program notes that during 2010 the SESC will seek to inspect approximately 150 Type 1 Securities and Asset Management firms. While that number may seem large, it is less than 30 percent of the total number of such firms registered in Japan, and the number supports the common perception that these firms will be inspected by SESC every three to four years. Moreover, out of these 150 inspections, 110 will be inspected by inspection resources of local finance bureaus (generally viewed as much less comprehensive than SESC inspections) leaving 40 major firms to be covered by the SESC itself.

No similar numbers are provided for firms holding only Type 2 Financial Instruments and Investment Advisory registrations. The 2010 Program states that these firms will be ''inspected on an ongoing basis'' but, since the 2010 Program is silent on the number of inspections, it appears likely that such inspections, as in the past, will be ''opportunistic'' and be initiated against specific firms generating consumer complaints or which have been involved in transactions that have gained public attention.

[1] Rating agencies became the subject of separate inspection in Japan from April 1, 2010.

Recommendations for Offshore Compliance Managers.

Some highlights from the 2010 Program for offshore compliance managers reviewing local compliance staff and procedures include the following:

■ Be ready for a close examination of capital related issues including capital adequacy and solvency calculations; prepare your firm's explanations of these items in advance, and be sure that local staff know how to explain the figures and methodology of calculation.

■ Confirm and be prepared to explain the firm's policy and practices on firm risk identification, management and control in detail. This includes ensuring that management understands the risk management process and can explain it clearly (i.e., do not rely only on risk management or compliance staff to tell the story—the SESC has made it clear that it expects management itself to be familiar with this topic); compliance groups should also be prepared to clearly articulate and explain the firm's various internal control systems.

■ Review your securities marketing and distribution functions to be sure that the procedures they operate under are disciplined, transparent and compliant; focus on documentation of suitability and customer disclosure (and the associated record-keeping to document these operations).

■ On the trading and investment side, be sure that you can demonstrate operational systems for identifying and preventing insider trading and market manipulation activities and have conducted sufficient training so that traders themselves can reflect the firm's strong compliance culture.

Almost all FIs that have experienced one or more SESC examinations will confirm that advance warning of what will be expected in an inspection makes it far easier to conclude one on a satisfactory basis. This fact underscores the need for close attention to the 2010 Program by compliance departments of all FIs with operations in Japan.