

Japan Exchange Regulation Inspection Plan for FY2024

March 25, 2024

Trading Participant Examination and Inspection Department
Japan Exchange Regulation

I. Basic Policy

Japan Exchange Regulation (JPX-R) is an organization dedicated to conducting self-regulatory operations for Tokyo Stock Exchange (TSE) and Osaka Exchange (OSE). JPX-R sets forth its basic policy as follows on inspecting trading participants to examine their compliance with laws, regulations, and exchange rules (hereinafter collectively "laws and regulations"), as well as their business operations and financial position.

1. Conducting inspections with expertise as an organization of the exchange group

JPX-R cooperates with exchange market operations and IT departments, and the clearing organization (Japan Securities Clearing Corporation) as a self-regulatory organization with close proximity to the market to conduct highly specialized inspections to ensure the fairness and reliability of exchange markets.

2. Monitoring trading participant's business operations and financial situation

JPX-R will gather and analyze information pertaining to trading participants (information on on-exchange trading activity, various statements and reports submitted by trading participants, disclosed information, past inspection results, results of inspections by other organizations, and information on clearing, etc.) in close collaboration with the Financial Services Agency (FSA) and the Securities and Exchange Surveillance Commission (SESC) and conduct monitoring based on the following principles.¹

(1) Targeted monitoring

If JPX-R is concerned about the existence of similar deficiencies on the part of multiple trading participants or considers it necessary to check, among other matters, the status of adjustments to amendments to laws and regulations or upgrades of exchange systems, JPX-R will conduct cross-sectional assessments of the actual conditions of trading participants by conducting surveys and

¹ Besides face-to-face contact, web-based meeting tools, email, and telephone are used.

interviews and requesting that the relevant companies initiate internal inspections.

Moreover, JPX-R will flexibly check the actual conditions of trading participants': (i) changes in management systems, financial conditions, and business execution systems; (ii) improvement of deficiencies; and (iii) operations deemed to present high risks. JPX-R will do so by actively using monitoring methods such as surveys and interviews, in addition to inspections.

(2) Regular communications

JPX-R will regularly contact the people responsible for inspection and related persons to assess issues specific to each company, internal control environments, and the like. Information on these matters may be hard to evaluate through written documents such as statements and reports submitted by trading participants.

3. Strengthening inspection based on a risk-based approach

JPX-R will strengthen inspections based on a risk-based approach through risk assessment of trading participants based on the results of inspections and monitoring. In order to manage trading participants effectively and efficiently, it will also aim for overall optimization of inspection and monitoring.

(1) Selecting trading participants for inspection based on risks

JPX-R will consider the risk assessment results and prioritize inspection of trading participants that are deemed to be high-risk.

If it considers it is necessary to make more in-depth checks without delay, JPX-R is also flexible for conducting inspections that focus on a specific item, regardless of the number of days etc. since the last inspection.

(2) Conducting flexible inspections based on the severity of risk

Based on the results of the risk assessment and the business conditions and individual situations of the trading participant to be inspected, JPX-R will select the items and themes to focus on during the inspection. The number of inspection days and number of inspection officials will be determined flexibly according to the severity of the risk.

4. Strengthening internal management systems of trading participants

If the investigations reveal any violation of laws and regulations or activities that are inappropriate for sound market operations, JPX-R will not only correct and follow up on the situation but also encourage the trading participant to take measures to strengthen its internal management systems for matters deemed to have a potential risk in the future by discussing issues with trading participants, including their management team, for example.

II. FY2024 Initiatives

1. Major changes in environment and rule revisions etc. to note for inspections

(1) Status of Violations in the Market, etc.

In FY2023, there was a case in which orders were accepted from customers to form artificial market quotations for IPO issues at a major online trading participant. (Disciplinary actions were taken by Tokyo Stock Exchange and Osaka Exchange in March 2024)².

During the inspections, numerous deficiencies were found in the status of system risk management systems, trading supervision systems for the prevention of unfair trading, and order management systems targeting activities such as low latency trading. A "Caution by the Standing Governor in Charge" was issued regarding a failure of data linkage to the system for trade surveillance that internally occurred at a trading participant.

(2) Changes in trading participant business models

Some participants have partially modified their business models by transferring their management rights in response to changes in the business environment³. Although we implemented ongoing monitoring of such trading participants in FY2023, there are some that still have issues with their business execution systems, such as in compliance functions and system-related matters.

(3) IT usage

² In addition, two other trading participants were found to have violated the suitability principle and the obligation to provide explanations based on customer attributes, resulting in disciplinary actions by Tokyo Stock Exchange and Osaka Exchange (September and November 2023, respectively).

³ For example, cases in which a business model focusing on face-to-face sales and dealing is changed to an online-only business have been identified.

During inspections, it was found that the development of manuals and similar materials for system failures was inadequate, and that the identification and assessment of system risks were insufficient.

In addition, there have been several recently confirmed cases in which customers have been affected by ransomware through unauthorized access by malicious third parties to multiple trading participants' systems. This has resulted in damages to customers, such as the suspension of some services, unauthorized withdrawals of customer funds, and leakage of customer information. Based on these occurrences, the Japan Securities Dealers Association (JSDA) has released guidelines⁴ and the Financial Services Agency (FSA) has published an "Analysis Report on Financial Institutions' Computer System Failures"⁵. Amid the increasing threat of cyber-attacks, trading participants are required to ensure stable system operations and thorough information security management based on these guidelines.

The TSE's cash trading system (arrowhead) is scheduled to be upgraded in November 2024, and trading participants will need to adapt their systems accordingly.

(4) Developments in Low Latency Trading, etc.

Also, at exchanges, the number of orders and trading volumes of low latency traders also account for a large share of the entire market⁶. Under these circumstances, some low latency trading brokers were found during the inspections to have deficiencies in the management of order placement limits, and some were found to have problematic adequacy of limits for accumulated positions, etc.

2. Priority Inspection Items, etc.

Based on the above-mentioned changes in the environment, inspections in FY2024

⁴ The Japan Securities Dealers Association, "Guidelines to prevent unauthorized access, etc. for or online trading" (established in March 2021, revised in July of the same year) (https://www.jsda.or.jp/anshin/inv_alerts/alearts04/index.html) (only available in Japanese)

⁵ The Financial Services Agency, "Publication of 'Analysis Report on Financial Institutions' Computer System Failures'" (June 30, 2023) (<https://www.fsa.go.jp/news/r4/sonota/20230630-2/20230630-2.html>) (only available in Japanese)

⁶ In January 2021, the Exchanges revised the "Rules concerning Order Management Systems at Trading Participants" and other rules, requiring that restrictions or measures related to customer order management be implemented under the direct and exclusive control of trading participants (the so-called Market Access Rule).

will focus on items from (1) to (3) as follows:

(1) Trading supervision systems to prevent unfair trading

JPX-R will examine whether trading participants have developed effective trading supervision systems that take the customer base into consideration. This includes identifying transactions that are likely to constitute unfair trading, conducting market surveillance, taking necessary measures, responding to inquiries on unfair trading from JPX-R (including information on investors who send original orders from overseas) conducting internal audits of trading supervision operations, and responding to an increase in the number of cases subject to market surveillance in light of recent market activity, in collaboration with JPX-R's Market Surveillance and Compliance Department.

Moreover, given the occurrence of a market manipulation case involving block offer transactions in FY2022 and a case in which orders were accepted from customers for artificial market formation transactions involving an IPO issue in FY2023 (followed by serious disciplinary actions against the relevant trading participants), JPX-R will examine the implementation of trade surveillance by trading participants for financing events that include block offers and IPOs, as well as other events that are considered to increase the risk of unfair trading⁷.

JPX-R will follow up on the status of companies introducing principle-based market surveillance⁸ and check with those who have introduced the approach as to whether or not the requirements for the introduction have been met, among other things. Furthermore, for those who have started or are considering the use of AI in market surveillance operations, JPX-R will also check whether they have formulated a framework that ensures the effectiveness of market surveillance (including gauging the effectiveness of said framework at launch and periodically thereafter).

⁷ At the "COMLEC Inspection Practitioners' Seminar" held by JPX-R in November 2023, cases involving trading participants were introduced under the theme of "Event Screening for the Prevention of Unfair Trading and Inspections on Proprietary Trading."

(The seminar materials are available in the December 4, 2023, notice to the person responsible for inspection and the Internal Administration Supervisor).

⁸ The Tokyo Stock Exchange (TSE) flexibly allows trade surveillance based on the business type and customer attributes of trading participants, provided that such participants have established a trading supervision system that meets certain requirements (Rule 4, Paragraph 1, Item 1, c. of TSE's "Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading").

(2) System risk management systems

JPX-R will check whether the development and operation of trading participants' computer systems for receiving and placing orders and settling trades are appropriately managed. If any systems-related operations are outsourced, JPX-R investigates whether or not trading participants check the status of such outsourced operations. If new technologies such as cloud services are used, it will investigate whether or not risks unique to those services are understood and risk-reduction measures according to the importance of data as well as applied business operations are implemented. In addition, we will examine the status of capacity management considering the recent booming market.

In addition, we will verify whether the remaining risks have been identified by comprehensively checking all systems and assessing the current countermeasures for critical systems. We will also evaluate vulnerability and threats, as well as whether or not sufficient countermeasures have been taken for identified risks.

Regarding system malfunctions, JPX-R will not only check whether there are effective measures in place to ensure stable system operations (such as development of procedures in response to disruptions in their own systems as well as exchange systems, etc., or development of alternative routes for major business operations) but also, for example, whether the causes of malfunctions have been identified and prevention measures have been appropriately formulated by addressing those causes.

In terms of cyberattacks, it will also check whether measures are taken to protect customers (such as appropriate management of IDs and passwords, identification of potential intrusion routes, and monitoring and restrictions on changes and additional cash withdrawal accounts), or effective measures (such as risk assessment, creation of response procedures, and implementation of training) are in place taking into account an increase in more sophisticated cyberattacks.

Regarding the cash trading system (arrowhead) scheduled to be upgraded in November 2024, we will examine the status of preparations and system development for the upgrade and related situations.

(3) Management systems pertaining to Low Latency Trading, etc.

JPX-R will continue investigations concerning whether trading participants

have developed order management systems for low latency trading and the like, including with regard to compliance with the Market Access Rule and the appropriateness of the limits on accumulated positions. It will also verify that an appropriate framework is in place for system management, data transmission management, and other factors related to low latency trading activities, including responses to abnormalities.

(4) Other matters to be observed during inspections, etc.

In addition to the above, JPX-R will inspect matters focusing on the following items based on the recent situations surrounding trading participants.

- Impact on the management structure, business plans including future business models, and business execution systems of trading participants that have undergone management transfers or reorganizations
- Besides the aforementioned cloud services, how trading participants have addressed digital transformation including the use of RPA or AI, as well as the use of related outsourcing firms
- Impact on Japanese companies with trading qualifications for certain reasons, such as when regulations overseas have changed and financial risk of overseas affiliates has been identified
- New trends such as new products and various services for securing profit sources to address matters including outflows of customer funds mainly due to aging customers and competition over lowering trading fees
- Status of response to the revision of best execution regulations
- Status of development of a management system for commodity futures trading, etc.

3. Information sharing with FSA, SESC, and other self-regulatory organizations

To contribute to the overall enhancement of trading participant oversight, JPX-R will continue boosting efforts by exchanging information, closely collaborating, and sharing views on problems with FSA, SESC, JSDA, and other exchanges.

4. Dissemination of information related to inspection activities

JPX-R will widely disseminate information regarding its approach to inspections and the status of inspections and measures. This is aimed at encouraging appropriate responses from trading participants by sharing JPX-R's inspection viewpoints and deficiencies identified in the inspections, and allowing parties related to the capital

market to gain an understanding of JPX-R inspection activities that are conducted to ensure the reliability of exchange markets.

5. Scope of inspections and support for improvement of internal management systems

Please refer to the Appendix for outlines of other inspections and support for trading participants.

Appendix

1. Scope of inspections

Trading participant inspections shall, as a general rule, be conducted within the following scope.

(1) Types of inspections

There are three types of inspections:

- General inspections of trading participants for which inspections are deemed highly necessary based on on-going analysis of trading participant's business operations and financial situation;
- Follow-up inspections conducted as needed to check for improvements within approximately one year after an inspection; and
- Special inspections that focus on specific issues based on a range of information.

(2) Joint inspections with other self-regulatory organizations

As a general rule, general inspections of general trading participants will be carried out jointly with JSDA and other financial instruments exchanges.

(3) Notice of inspections, etc.

Where an inspection is to be carried out, notice will be given to the representative of the trading participant. As a general rule, the trading participant will be notified of the start date and method, etc. of the inspection approximately four weeks in advance and the names, etc. of the inspection staff will be provided approximately two weeks prior to the start date.

In an inspection, JPX-R will request, in advance, personnel responsible for inspections at the trading participant subject to the inspection to prepare various materials required for the inspection⁹.

(4) Inspection method

Inspections are classified into on-site inspections, in which JPX-R staff visit the headquarters and other offices of trading participants, and document-

⁹ The formats for materials to be prepared in advance are available from Target. Note that, depending on the features of the trading participant's business and other factors, we may ask the trading participant to prepare materials in advance in addition to the default format.

based inspections, which are based on submitted documents.

During an on-site inspection, JPX-R will examine various documents including books and records. At the same time, JPX-R will analyze the actual operations of trading participants from multiple perspectives through conversations with their officers and employees and inspect issues in question, etc. in relation to their business operations.

(5) Duration of inspection and number of inspection staff

The duration of an inspection and number of inspection staff will be determined in accordance with the degree of risks and related factors, based on the size of and actual conditions at each trading participant.

(6) Explanation of inspection results, etc.

After an inspection is completed, the representative of the trading participant and personnel responsible for overall internal management, etc. will receive a verbal explanation of the inspection results and the assessment status of internal management systems, etc. The representative of the trading participant will also receive notification of the inspection results.

(7) Actions taken based on inspection results

In order to protect public interest and investors, if the results of an inspection reveal an infringement of laws and regulations, TSE will impose disciplinary action¹⁰ on or issue a recommendation to; or otherwise, issue cautionary notice to or take other actions as indicated in the chart below against the trading participant¹¹.

	Infringement of laws and regulations	Deficiency of internal management, etc.
Disciplinary action, etc.	Revocation of trading qualification	Recommendation
	Suspension or restriction of trading, etc.	
	Imposition of financial penalty	
	Public censure	

¹⁰ Refer to Points of Consideration when Deciding Disciplinary Actions (July 16, 2013)

¹¹ The decision on the type of disciplinary action, etc. will be based on a comprehensive evaluation of various aspects, including whether or not there has been willful misconduct or gross negligence on the part of the officers or employees of the trading participant, the severity of the infringement, and the status of internal management systems.

Cautionary notice, etc.	Caution by the Standing Governor in charge	Request
	Caution by the Director of Participant Examination and Inspection Dept.	
	Caution by the inspector	

(8) Opinion sharing and appeals following inspection

Every effort is made to align JPX-R and the trading participant's understanding of conditions by exchanging opinions, etc. following the inspection. In the event of differing opinions, the trading participant may submit an appeal to JPX-R¹².

(9) Improvements made on deficiencies by trading participants

Inspection staff continuously monitors progress on improvements on problems identified by inspections and takes steps to ensure trading participants make improvements. They also provide consultation and other forms of support for improvement as needed.

(10) Feedback survey

JPX-R gathers a wide variety of opinions regarding its inspection activities. It conducts surveys with inspection-related personnel mainly via email following the release of inspection results in order to improve inspection operations.

2. Support for trading participants

JPX-R works to support participant-driven improvement of internal management systems by making easy-to-understand announcements on and providing explanations of areas of focus, past cases, and other matters using the seminars and materials below. If anything is unclear or if there are any concerns about day-to-day business operations, please contact JPX-R.

(1) Seminars for inspection-related personnel

JPX-R will hold seminars for inspection-related personnel to explain matters such as inspection examples and regulatory details with the aim of improving the understanding of laws and regulations among personnel responsible for compliance at trading participants.

¹² When JPX-R receives an appeal, after considering the content of the appeal, it will hold conversations as needed and make an impartial judgment.

(2) Compliance seminars

JPX-R will send staff to trading participant offices to give compliance seminars on issues identified during recent inspections.

(3) Revision of the Compliance Case Studies

JPX-R will revise, as needed, Compliance Case Studies summarizing inquiries received from trading participants and measures taken in response to issues identified during inspections.

(4) Revision and Publication of checkpoints pertaining to trading participant internal management systems

Points of regulatory concern for primary inspection items and management system checkpoints for each item will be revised as needed and published on the JPX-R website as a reference for the development of trading participant internal management systems.

(5) Publication of inspection result statistics

JPX-R compiles and releases inspection results and issues identified to trading participant representatives and personnel responsible for inspections.

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