

JSDA (Audit) 16 No.522
November 26, 2004

To: Member representatives
From: Hiroshi Koshida, Chairman, Japan Securities Dealers Association

Results of Audits of Member Firms in First Half of 2004 Fiscal Year, Specific Details, and Notes

This is to advise you that the JSDA has summarized the "Results of Audits of Member Firms in First Half of 2004 Fiscal Year" (see Exhibit 1).

The audits on member firms in the first half of the 2004 fiscal year consisted of standard audits on 46 member firms.

The audit results of the standard audits on 46 member firms showed that insufficient understanding of laws and ordinances and a lack of thoroughness in rule observance awareness and internal controls, etc. have led to continuing instances of trust fund shortages in segregated client funds and canvassing by unregistered persons, etc. in (1) statutory matters.

The audit results continued to show continuing instances of inadequacies in internal control besides breaches in matters such as giving business to local dealers in (2) JSDA Rules, etc.

Focusing on items where there are many breaches of the law and ordinances, etc., the JSDA has summarized the "Specific Details of Results of Audits of Member Firms in first half of the 2004 fiscal year and Notes" in Exhibit 2. You are requested to use them as a reference in the training of executives and staff and in internal audits (inspections), etc. to ensure familiarity and observance of laws and ordinances and rules within member firms.

Let me add that a copy of these documents (Exhibits 1 and 2) will be sent to the overall internal control administrators.

If you have any questions regarding these matters, please contact the Audit Dept, JSDA (Tel 03-3667-8007).

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EXHIBIT 2

SPECIFIC DETAILS OF RESULTS OF AUDITS OF MEMBER FIRMS IN FIRST HALF OF 2004 FISCAL YEAR AND NOTES

November 2004

Statutory Matters

1. Trust Fund Shortages in Segregated Client Funds (1 Firm)

Cases of trust fund shortages occurred as a result of the responsible department (responsible officer) underestimating the required amount of segregated client funds as a result of misinterpretations of the law, misunderstandings of the calculation method due to inadequate understanding, or a failure to make the calculation.

These breaches of the law went undetected because staff did not familiarize themselves with or put into practice the JSDA Q&A on the segregation of client assets or specific cases and notes on audit results or because matters were left to the responsible officer and checks within the divisions responsible for internal controls were not implemented

Please refer to the specific details and notes of the 2002 and 2003 fiscal years for cases and notes relating to the 2002 fiscal year and before.

Cases

(i) Omission of posting of cash retained at sales branches, etc.

Shortages in trust funds were found to have occurred 16 times between March 2002 and March 2003 as a result of cash that had been retained at sales branches, etc. without settlements with clients being conducted after the processing of disbursements, not being counted in the required amount of segregated client funds.

Causes, etc.

Because the firm had received a reminder on the treatment of cash retained at sales branches in the previous JSDA audit, the settlement department manager had given verbal instructions to the entire sales branch to be sure to process re-deposited cash on the second day after the cash was retained for any reason whatsoever in relation to cash retained at a sales branch without a settlement being conducted with the client after disbursements processing.

However, because the instructions on the treatment of cash retained at the sales branch were only given verbally, the treatment was not thoroughly publicized. Furthermore, the retention of cash was overlooked because there was no procedure in place to check sales branch cash retentions by having them reported to head office every business day.