

Client Alert.

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Amendment to Japanese Investment Management Regulations in Response to AIJ Incident

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On October 12, 2012, in response to the recent AIJ scandal, the Financial Services Agency of Japan (the “Japanese FSA”) published a draft amendment to certain rules (“Draft Rules”) intended to revamp the regulation and supervision of discretionary advisory businesses, particularly with respect to employees’ pension fund (*kōsei nenkin kikin*) clients. The Draft Rules effectively impose an audit requirement on funds into which investment managers invest client assets, and require the investment manager to establish processes for independent third party verification of fund NAV, except when clients are specified investors (*tokutei tōshika*). The Draft Rules also expand disclosure obligations for discretionary investment managers and the scope of supervision by the Japanese FSA. The Draft Rules were open to public comments until November 12, 2012.

1. AIJ INCIDENT

AIJ Investment Advisors Co., Ltd. (“AIJ”) was a Tokyo-based alternative investment manager that managed primarily Japanese pension fund assets. In January 2012, an investigation by the Securities and Exchange Surveillance Commission revealed that AIJ had long falsified its performance and that, in fact, it had been operating a fraudulent Ponzi scheme, whereby the majority of its clients’ assets, in an amount of approximately JPY 200 billion (USD 2.5 billion), had disappeared.¹

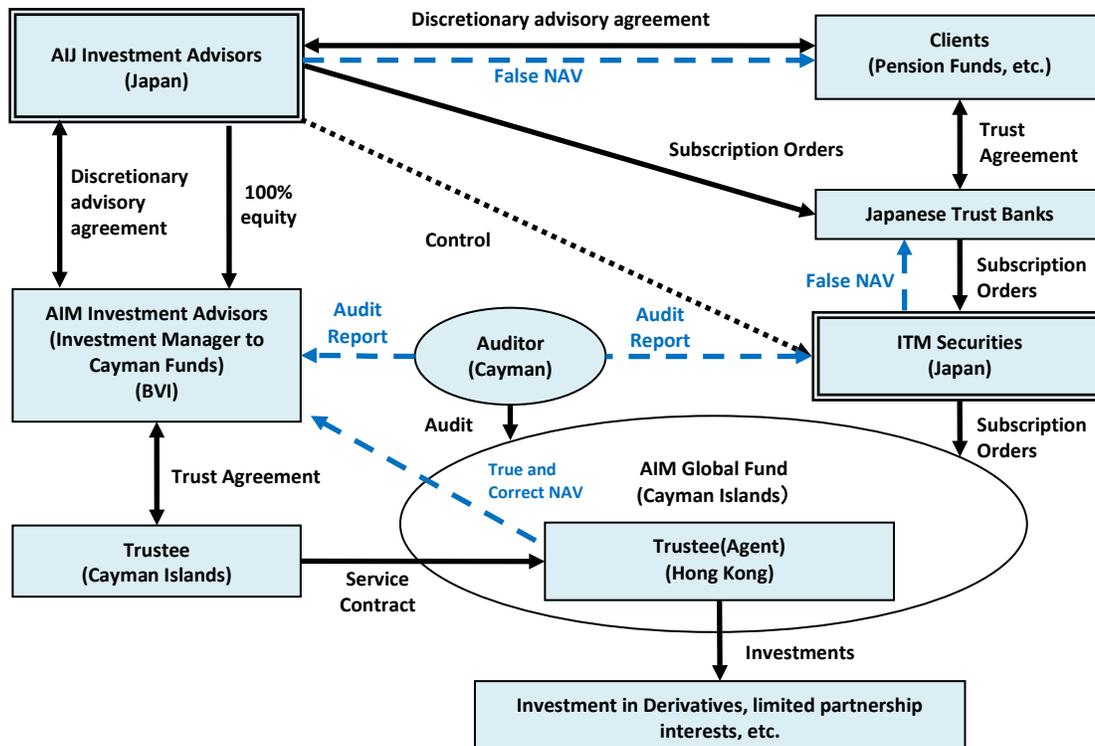
AIJ utilized a scheme involving funds established in the Cayman Islands to invest in derivative transactions, partnerships and similar investments. Assets entrusted to AIJ by clients pursuant to a discretionary investment management agreement were invested in Cayman funds managed by AIJ’s affiliates. Another AIJ affiliated company handled marketing and sales of the Cayman funds to Japanese pension funds.

Although audit reports on the Cayman funds received by AIJ from the auditor and trustee of the funds reflected accurate NAV, AIJ falsified fund NAV in the reports it delivered to its clients and the Japanese trust banks acting as custodian for client managed assets.² A number of AIJ pension fund clients had delegated management of a substantial portion of their assets to AIJ and suffered huge losses, inevitably resulting in self-dissolution of the pension fund.

¹ In March 2012, the Japanese FSA cancelled AIJ’s registration as investment manager under the Financial Instruments and Exchange Law. Also, individuals including the representative of AIJ have been indicted for frauds to clients.

² The typical AIJ pension fund clients seemed to be mainly employee’s pension funds (*kōsei nenkin kikin*) and defined benefit corporate pension funds (*kakutei kyūfu kigyō nenkin kikin*). These pension funds must delegate management of their assets to a trust bank, an insurance company or a registered investment manager except for those pension funds that are allowed to conduct in-house management in certain types of assets by satisfying the internal control requirements.

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(Note) Prepared based on material published by the Securities and Exchange Surveillance Commission.

2. PROPOSED AMENDMENTS IN DRAFT RULES

(1) Overview of Proposed Amendments

In advance of the publication of the Draft Rules, in September 2012, the Japanese FSA announced the outline of a proposal to amend laws and regulations aimed at achieving the following:

- enhanced fund monitoring by securing effective checking by Japanese trust banks and other third parties
- enhanced disclosure to investment management clients (especially pension funds)
- increased criminal penalties for violation of investment management regulations
- enhanced regulations applicable to investment managers

The Draft Rules address the above-mentioned matters by way of amendment to cabinet orders and ministerial ordinances which do not require legislative action. It is expected that matters (such as increasing the statutory limit on criminal penalties) requiring an amendment to laws will be submitted for approval at the forthcoming Diet session.

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(2) Amendment to Rules Applicable to Investment Managers

A. Monitoring by Japanese Trust Banks

Under Japanese law, when entering into a discretionary investment advisory agreement with a registered investment manager, clients generally appoint a trust bank to take custody of the managed assets. The Draft Rules will introduce a monitoring requirement on Japanese trust banks with respect to target funds in which the investment manager invests the assets of clients who are not specified investors (*tokutei tōshika*).

- a. An investment manager cannot purchase target fund securities on behalf of a client^{3,4} if it does not satisfy the following requirements:
 - take measures to enable the Japanese trust bank to know the true and correct values of target fund securities by either (i) causing the Japanese trust bank to directly receive such information at least once every six (6) months (or every three (3) months for employees' pension funds) from the person who calculates such values or (ii) taking measures to secure the ability of the Japanese trust bank to directly confirm such values with such persons;
 - have the funds audited by independent auditors satisfying the requirements set by the Investment Advisors' Association of Japan⁵; and
 - take measures to enable the Japanese trust bank to receive the true and correct audit reports of the fund, together with financial statements.
- b. The investment manager must provide the Japanese trust bank with the same information concerning invested securities as that contained in management reports (*unyō hōkoku sho*) delivered to investors.
- c. The Japanese trust bank must establish an internal system to cross-check the reported value of target assets and to notify the result to clients.

B. Enhanced Disclosure and Mechanisms to Reveal Problems

a. Disclosure at Time of Entering into Investment Management Agreement

The Draft Rules require that investment managers must include the following additional information in statutory explanatory documents delivered to clients at the time of entering into a discretionary investment advisory agreement: (i) the identity of target fund(s) in which client assets are planned to be invested (if any); (ii) the method and frequency of calculating and disclosing target fund NAV; (iii) the names and functions of entities involved in managing and operating the target funds and the relationship among such entities; and (iv) whether or not the target fund is audited by independent auditors.

³ The fund securities to which the new requirements apply will be domestic or foreign (i) investment trust units; (ii) investment corporation units and bonds; (iii) trust beneficiary certificates similar to (i) or (ii); and (iv) collective investment scheme (e.g., partnership) interests.

⁴ Japanese investment trusts investing only in listed stock or certain other assets or fund securities listed on certain designated foreign stock exchanges are excluded from the fund securities subject to this new regulation (2)A.a.

⁵ In addition, under the proposed amendment to the guidelines, with respect to funds managed by the investment manager or its affiliates, the investment manager must make efforts to maintain independence and effectiveness of audit.

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b. Management Report Disclosure

Management reports delivered to clients will be required to include additional information, including a summary and historical asset management records as well as a summary of the audit conducted on the operations or financial conditions of the investment manager (if conducted⁶).

The frequency for delivery of the management reports will be increased to at least once every three (3) months for employees' pension fund clients.⁷

c. Limitations on Client's Ability to Become Specified Investors (*tokutei tōshika*)

The requirements mentioned in A. and B. above generally do not apply if the clients are "specified investors" (*tokutei tōshika*). Other than large pension funds, pension funds are generally not specified investors, however, they can elect to be treated as a specified investor with the consent of the investment manager. However, the amended guidelines will clarify that investment managers should grant consent only after considering the client's knowledge, experience, status of assets and investment objective.

d. Obligation Applicable to Management of Employees' Pension Funds' Assets

An investment manager must notify an employees' pension fund client when concentration limits set by the pension fund are at risk of being breached.⁸ Additionally, the investment manager must establish internal processes to ensure appropriate explanation of prospective returns and losses on client assets pursuant to the basic investment policies set by the pension fund client.

C. Enhanced Regulation of Investment Managers, Etc.

a. Items Reported to Regulatory Authority

Information in annual business reports (*jigyō hōkoku sho*) filed with the Japanese FSA will also be expanded to cover information such as the NAV of target funds as well as a summary of the external audit conducted on the investment manager (if any).

b. Prohibition on Complying with Investment Instructions of Employee's Pension Fund Clients

The current Employees' Pension Funds Law requires employees' pension funds to delegate all investment decisions to an investment manager. The Draft Rules clarify that investment managers may not comply with instructions from employees' pension funds to invest in, or dispose of, specific securities. Investment managers must not market products or provide performance explanations in a way that is likely to induce the client to give instructions for making specific investments.

⁶ Under the Company Law of Japan, if an investment manager is (i) a large company (*dai kaisha*), defined as a joint stock corporation with stated capital of JPY 500 million or more or liabilities of JPY 20 billion or more based on the latest annual balance sheet or (ii) a committee-type company (*iinkai setchi kaisha*), its financial statements must be audited by an independent auditor. Additionally, if the investment manager is a reporting company under the Financial Instruments and Exchange Law (such as a listed company or an asset management company that manages publicly-offered investment trusts), its financial statements must be audited pursuant to the requirements under the same law.

⁷ In other cases, at least once every six (6) months, being the same as under the current rules.

⁸ According to the FSA, concurrently with the introduction of this obligation on investment managers, a pension fund will be required to notify the investment manager of certain information, including total assets.

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c. Asset Management Consultants and Marketing of Investment Management Services

In the AIJ incident, a pension consultant who was a former Japanese government official played a major role in recommending pension fund clients to retain AIJ as investment manager. The Japanese FSA found that the nature of the consulting services performed by the consultant constituted regulated investment advisory services. The Draft Rules clarify that the provision of consulting services in relation to the selection of investment managers or asset management of employees' pension funds requires registration under the Financial Instruments and Exchange Law if it includes advice on the value of securities.

Additionally, intermediaries for investment management relationships must disclose potential conflicts of interest to prospective clients when retained by an investment manager to solicit client mandates.

(3) Amendments to Trust Business Laws and Insurance Business Laws

The Draft Rules also include amendment of the regulations under the Trust Business Law and the Insurance Business Law, including disclosure obligations with respect to target fund securities held for client portfolios and explanation requirements with respect to the investment management services offered to clients by licensed trust banks or insurance companies.

3. OTHER RECENT DEVELOPMENTS AFFECTING JAPANESE PENSION FUNDS

(1) Amendment to Guidelines for Management of Employees' Pension Fund Assets

In response to the AIJ incident, on September 26, 2012, the Ministry of Health, Labor and Welfare of Japan (the "MHLW") amended the guidelines regarding asset management of employees' pension funds. Effective from April 1, 2013, it will be a mandatory requirement for an employees' pension fund (i) to establish a strategic asset allocation policy, (ii) to provide for policies on concentration limits, and (iii) to establish a basic policy and conduct due diligence with respect to alternative investments.

(2) Proposed Abolition of Employees' Pension Fund (*kōsei nenkin kikin*) System

The AIJ incident also shed light on structural problems of the Japanese employees' pension funds system, whereby pension funds are effectively able to leverage scale efficiencies achieved by being entrusted to manage and pay the government sponsored pension. The 2002 amendment of the Employees' Pension Funds Law has allowed employees' pension funds to be released from the obligation to pay the governmental portion of pension payments by returning the corresponding assets to the Japanese government. However, because of a shortage of funds to return assets, many employees' pension funds (especially those formed by mid-to-small size Japanese companies) have not been able to obtain a release from such obligations. On September 28, 2012, the MHLW published a plan to abolish the employees' pension fund system following a transitional period. The MHLW has announced that it aims to propose a specific plan by the end of this year and submit a bill to effectuate such reform at the next Diet session.

(3) Amendment to Pension Accounting under J-GAAP

Effective for fiscal years commencing on or after April 1, 2013, Japanese GAAP will require Japanese companies to recognize actuarial gains/losses and prior service costs that are not required to be recognized under the current J-GAAP in other comprehensive income on the consolidated balance sheets. This amendment may have an impact on

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the investment activities of pension assets, accelerate the trend of reducing levels of pension payments or of returning the governmental portion of pension asset management by employees' pension funds.

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