

ClientAlert

Tokyo Financial Services Group

September 2012

FSA's Proposal to Prevent the Recurrence of the AIJ Scandal and the Results of Second Survey

On September 4, 2012, the Financial Services Agency of Japan ("FSA") published its proposal of measures to prevent the recurrence of the AIJ scandal while providing the opportunity to the public to provide their opinions regarding such measures by October 4, 2012. In addition to the foregoing, the FSA also published the interim results of the second survey that the FSA commenced this April regarding certain discretionary investment management companies ("DIMs") selected by the FSA in accordance with the first survey.

FSA's Proposal to Prevent the Recurrence of the AIJ Scandal

Different from the normal protocol, the FSA published its proposals without a specific draft of the relevant regulations. The absence of this draft of the regulations may be due to the significant FSA concerns regarding the AIJ scandal and the FSA's wish to consider as many ideas as possible prior to preparing a draft of the regulations.

The FSA's proposal consists of four parts: (1) establishing a system by which domestic trust banks can properly confirm the consistency of the fund NAV information provided by the administrator, the external auditor and the DIM; (2) improving the support system to assist clients (pension funds) to become aware of issues with respect to their investments; (3) revising the penalties and fines for certain illegal acts; and (4) reforming regulations governing the activities of DIMs generally.

(1) Establishment of a System by Which Domestic Trust Banks Can Properly Confirm the Consistency of the Fund NAV Information Provided by the Administrator, the External Auditor and the DIM

If a DIM enters into an investment management agreement with a pension fund and also enters into a trust agreement with a domestic trust bank that has a pension fund beneficiary, the DIM will be required to:

- (a) Make the necessary arrangement so that domestic trust bank is able to obtain the NAV of the fund directly from the fund administrator;
- (b) Limit investments only into funds subject to external audits and make the necessary arrangements so that the domestic trust bank is able to obtain an authentic audit report; and



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- (c) Send the domestic trust bank the NAV information of the fund as indicated in the investment management reports delivered to clients.

Also, the domestic trust bank will be required to match the data prescribed in the three reports described in (a)~(c) above and report the result of such process to the pension fund clients.

(2) Improving the Support System to Assist Clients (Pension Funds) to Become Aware of Issues with Respect to Their Investments

The FSA proposed the following four measures to support pension fund clients to become aware of relevant issues with respect to investments:

- (a) Increasing the information required to be described in the disclosure documents or the investment management reports that must be delivered to clients (such as information on the fund scheme, the calculation methodology of the NAV of the fund, external audits, etc.);
- (b) Requiring the delivery of the investment management reports more frequently (on at least a quarterly basis);
- (c) Imposing tighter requirements for pension funds to meet the requirement to be a professional investor (*tokutei touseika*); and
- (d) Requiring an investment manager (i) to notify its clients where there is a likelihood of a breach of its obligation to diversify investments, and (ii) to organize systems to explain risks to clients depending on their knowledge and experience.

(3) Revising the Penalties and Fines for Certain Illegal Acts

More specifically, the FSA also proposed imposing heavier penalties on false statements or solicitations made by DIMs.

Acts	Current	Proposal
False statements in the investment management reports	not more than <u>6 months</u> penal servitude or not more than <u>JPY 0.5 million</u> penal fine (for company: not applicable)	not more than <u>3 years</u> penal servitude or not more than <u>JPY 3 million</u> penal fine (for company: <u>JPY 300 million</u>)

Acts	Current	Proposal
False statements in the notice with respect to the solicitation	not more than <u>1 year</u> penal servitude or not more than <u>JPY 1 or 3 million</u> penal fine (for company: not applicable or <u>JPY 200 million</u>)	not more than <u>3 years</u> penal servitude or not more than <u>JPY 3 million</u> penal fine (for company: <u>JPY 300 million</u>)
The use of fraudulent means to execute an investment management agreement	not more than <u>3 years</u> penal servitude or not more than <u>JPY 3 million</u> penal fine (for company: <u>JPY 300 million</u>)	not more than <u>5 years</u> penal servitude or not more than <u>JPY 5 million</u> penal fine (for company: <u>JPY 500 million</u>)

(4) Reforming Regulations Governing the Activities of DIMs

The FSA considered reviewing and reforming the manner to regulate, supervise and inspect DIMs and proposed the following measures:

- (a) Increasing the information required to be described in annual business reports (such as information on the fund scheme, the calculation methodology of the NAV of the fund, external audits, etc.);
- (b) Strengthening the regulators' supervision responsibilities for DIMs (such as revising the guidelines, implementing offsite monitoring corresponding to risks a DIM commonly takes, etc.);
- (c) Implementing intensive inspections and setting up and utilizing the "Pension Investment Hotline"; and
- (d) Reinforcing the system for inspection and supervision (such as information gathering, monitoring, staffing, etc.) of asset managers generally.

In addition, on September 4, 2012, the Japan Investment Advisers Association ("**JIAA**") published their plan to prevent recurrence of the AIJ scandal. The JIAA plan is consistent with the FSA's proposal.

Results of Second Survey

The FSA also published an interim report regarding the results of the second survey of asset managers in Japan commenced in April of this year. In the report, the FSA first explained the outline of the selected DIMs that were subject to the second survey. More than 90% of the selected DIMs have an AUM of less than JPY 500 billion and a half of the selected DIMs have an AUM of less than JPY 50 billion. Of approximately 40% of the selected DIMs, more than 80% of their clients are pension funds. 36.3% of the selected DIM are subject to external audit and 93.1% of the DIMs are members of the JIAA.

Second, the report outlines the extent of control that such DIMs had with respect to third parties particularly in circumstances where the selected DIMs incorporated foreign funds into their portfolios. 26.5% of the selected DIMs are controlled by the investment manager that manages the foreign funds. On the other hand, 96.1% of the selected DIMs appoint an independent administrator to calculate the relevant fund's NAV. 97.1% of the selected DIMs answered that their underlying client or trust bank is registered as the unit holder of the foreign fund (this suggests that the AIJ arrangement where the registered holder was the distributor securities firm is not so common in practice).

Lastly, the reports provided information on the status of investment management and strategies being employed. 21.6% of the selected DIMs incorporate collective investment scheme interests into their portfolios and only 9.8% of the selected DIMs incorporate portfolios containing un-listed stocks.

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