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Strengthened Regulations on Discretionary Investment Management Businesses in Response to AIJ Scandal

By Osamu Adachi & Takahiko Yamada

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Kazuhiko Asakawa, former president of AIJ Investment Advisors Co., Ltd. (“AIJ”), was sentenced to 15 years in prison by the Tokyo District Court on 18 December 2013 for defrauding pension funds of approximately 24.8 billion yen. He was found guilty of fraud and violation of the Financial Instruments and Exchange Act of Japan (the “FIEA”) with fraudulently concluded contracts. He immediately filed an appeal and the case is not closed.

AIJ, a Tokyo-based discretionary investment management firm, allegedly won discretionary investment management contracts to manage Japanese pension fund assets

using falsified results. AIJ’s scheme involved off-shore funds established in Cayman Islands managed by AIJ’s affiliates in which the Japanese pension fund assets entrusted to AIJ were invested. AIJ delivered reports including falsified NAVs for those

Cayman funds to its Japanese pension fund clients and the Japanese trust banks acting as custodians for those clients.

Following the AIJ scandal, the Financial Services Agency of Japan (“FSA”) reviewed the regulations on discretionary investment management businesses and consequently amended and strengthened the relevant Cabinet Office Ordinances and Guidelines in December 2012. It also submitted a bill to amend and strengthen the

FIEA to the Diet which was passed in June 2013. These amended regulations have already come into effect.



Monitoring by Japanese Trust Banks

In Japan, when a pension fund enters into a discretionary investment management contract with a discretionary investment manager,

the pension fund generally entrusts its assets to a Japanese trust bank as custodian. The amended Cabinet Office Ordinances and Guidelines require a discretionary investment manager investing assets of a pension fund that is not a certain type of professional investor (tokutei-toshika) into a fund (such as an off-shore fund) to take the measures set forth below so that a Japanese trust bank may monitor the NAV and other information of such target fund:

(i) measures enabling a Japanese trust bank to monitor the NAV of each target fund, being specifically: (a) measures to ensure that a Japanese trust bank can directly receive such information from the target fund’s administrator or another person calculating the NAV of such target fund at least every six months (or every three months for employees’ pension funds); or (b) measures to ensure that a Japanese trust bank can directly confirm the NAV with the target fund’s administrator or another person calculating the NAV of such target fund;

(ii) measures limiting investments to target funds subject to external audit and enabling a Japanese trust bank to receive true and correct audit reports for each target fund, being specifically: (a) measures to ensure that a Japanese trust bank can receive an audit report directly from an external auditor of such target fund, (b) measures to ensure that a Japanese trust bank can receive an audit report for such target fund indirectly through persons other than those related to investment managers, or (c) other measures to ensure that a Japanese trust bank can receive true and correct audit reports for such target fund; and

(iii) provision to a Japanese trust bank of the same NAV information for each target fund as is stated in management reports delivered to investors.

A Japanese trust bank acting as custodian for a pension fund is also required to establish a system whereby the Japanese trust bank may verify the NAV obtained through the above measures and notify it to

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the pension fund.

Mechanism for Investors to Detect Problems

The amended Cabinet Office Ordinances and Guidelines also require a discretionary investment manager to take the additional measures set forth below to allow investors (such as pension funds) themselves to detect problems with their investments (excluding items (i), (ii) and (iv) below if the pension funds are certain types of professional investors (tokutei-toshika)):

(i) inclusion of certain information in statutory explanatory documents to be delivered to an investor prior to the execution of a discretionary investment management contract and in management reports, such as (a) details of the scheme of each target fund in which assets are invested (e.g., parties' names and roles), (b) method of calculation of the NAV, (c) whether or not external audits are or will be conducted, and (d) investment process and other information;

(ii) delivery of an management report to the pension fund every three months (please note that, if the investor is not a pension fund, the management report has to be delivered to such investor every six months);

(iii) provision of notice to an employee's pension fund if a discretionary investment manager becomes aware of any risk of violation of the statutory obligation of the employee's pension fund to diversify its investments under the Employee's Pension Insurance Act;

(iv) establishment of a system to provide explanations to an employee's pension fund regarding the risks of investment in accordance with a basic policy set forth by the employee's pension fund itself at a level appropriate to its knowledge and experience; and

(v) prohibition on following specific investment instructions from an employee's pension fund. In this regard, under the Employee's Pension Insurance Act, where investment management has been delegated to

a discretionary investment manager based on a discretionary investment management contract, an employee's pension fund is required to entrust such manager with full discretion in making investments.

Strengthened Supervision over Investment Managers

In order to strengthen the legal framework to assess the current status of a discretionary investment manager by the FSA, the amended Cabinet Office Ordinances and Guidelines require the following additional information to be included in its business reports to be filed with the FSA:

(i) details of the scheme of each target in which assets are invested (e.g., parties' names and roles);

(ii) whether or not external audits are or will be conducted; and

(iii) certain indices (e.g., the number of contracts, returns on assets, total amount of assets, amount of management fees, percentage of each pension fund's assets).

Increased Criminal Penalties

The amended FIEA increased penalties as follows. The penalty for using fraudulent means to conclude discretionary investment management contracts was increased to imprisonment of up to five years and/or a fine of up to five million yen (and/or a fine of up to 500 million yen in the case of corporations). The penalties for the solicitation of investors by providing false information and for the inclusion of false statements in management reports were also increased to imprisonment of up to three years and/or a fine of up to three million yen (and/or a fine of up to 300 million yen in the case of corporations).

Conclusion

In addition to the amendments to the relevant regulations above, the FSA's supervision and inspection over discretionary investment managers has been enhanced in response to the AIJ scandal. Soon after the AIJ scandal was uncovered, investigations of all

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discretionary investment managers were implemented and hearings from such managers are still being held continuously in order to obtain more information about investment management businesses. Discretionary investment managers need to pay more attention to legal compliance issues when operating their businesses, such as by increasing employees' awareness of compliance matters and improving their internal compliance systems.

Mr. Osamu Adachi is a partner at Anderson Mori & Tomotsune. He has extensive experience in advising both Japanese and foreign clients on financial transactions and regulations (including fund regulation), mergers and acquisitions and other corporate matters. Osamu is admitted to the bar in Japan and New York. He has an LL.B. from The University of Tokyo and an LL.M. from Columbia University School of Law.

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Takahiko also served on secondment from July 2009 through February 2012 as deputy director of the Financial Markets Division, Planning and Coordination Bureau of the Financial Services Agency of Japan, where he was responsible for all aspects of law and regulations governing investment management businesses and participated in the development of new legislation.

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