

## Strengthened regulation of asset management industry adopted in response to the AIJ scandal

On 12 June 2013 the Japanese Diet passed a bill (the "Bill") to amend the Financial Instruments and Exchange Act of Japan and certain other laws, which will have a significant impact on foreign financial institutions operating in Japan. These amendments include additional regulations which will be imposed on the asset management industry in response to last year's AIJ scandal. This client briefing explains the background to and summarises these additional regulations and highlights their impact on non-Japanese asset managers.

### Background to the Amendments

The origins of the Bill can be traced back to the AIJ scandal in 2012. The AIJ scandal involved the loss of a large amount of pension fund assets which were managed by AIJ Investment Advisors Co., Ltd. ("**AIJ**"), a Tokyo-based investment management firm. Many of AIJ's clients were pension funds in Japan, for which AIJ was acting as a discretionary investment manager. Many of AIJ's pension fund clients had invested their assets in an offshore fund managed by a subsidiary of AIJ. Significant losses in these investments arose due to failed investments at the offshore fund. In addition, it was discovered that AIJ had been providing false investment reports containing false figures to its clients, deceiving them for some time about their losses. On 23 March 2012, the regulator revoked AIJ's investment management licence.

Following the AIJ scandal, the Financial Services Agency of Japan (the "**FSA**") set out to strengthen the regulations applicable to investment management firms and trust banks acting as trustees for pension funds. On 13 December 2012, the FSA published the amendments to the relevant Cabinet Office Ordinances and Guidelines. These amendments are summarised in "*2012 Amendments to the Cabinet Office Ordinances and Guidelines*" below. With the intention of strengthening the regulations even further, the FSA submitted the Bill to the Diet on 16 April 2013. The key amendments under the Bill are summarised in "*2013 Amendments pursuant to the Bill*" below.

### 2012 Amendments to the Cabinet Office Ordinances and Guidelines

The amendments to the Cabinet Office Ordinances and Guidelines in December 2012 introduce a system that requires investment management firms and trust banks to monitor more closely the funds in which their clients' pension assets are invested. Key elements of the 2012 amendments include:

- (i) the introduction of effective mechanisms for third party oversight (i.e., monitoring by trust banks);
- (ii) the introduction of effective mechanisms for clients (including pension funds) to detect problems or issues with their investments; and
- (iii) the enhancement of the reporting requirements imposed on investment managers.

Under the new regulations if an investment manager invests assets of a pension fund which is not categorised as a "professional investor" under Japanese law in certain types of funds (including foreign investment trusts, investment corporations and collective investment schemes), the investment manager must:

- (a) ensure that the trustee can obtain information on the value of the fund directly from the administrator of the fund and obtain an audit report from an external auditor; and
- (b) promptly provide the trustee with information on the value of the fund in a portfolio management report provided by the investment manager to the pension fund.

The trustee is also required to verify the information obtained from the administrator, the audit report and the information in the portfolio management report.

The new regulations come into force on 1 July 2013 (although part of the new regulations took effect on 1 April 2013). These changes may impose a significant burden on both Japanese investment managers and trustees and on non-Japanese firms selling or managing certain funds which are to be sold to Japanese pension funds. For example, under the new regulations foreign investment funds which are not audited by a third party auditor cannot be sold to pension funds which are not categorised as a "professional investor" under Japanese law. In addition, administrators of funds subject to the new regulation must provide information on the fund directly to the trustee.

## 2013 Amendments pursuant to the Bill

The Bill is intended to further strengthen the regulations applicable to management of pension fund assets. The Bill:

- (i) increases criminal penalties applicable to investment managers who have engaged in false reporting to clients and who commit certain other offences (this will take effect in July 2013); and
- (ii) tightens the eligibility requirements for a pension fund to be categorised as a "professional investor" (this will take effect within one year).

As described above, the 2012 amendments to the Cabinet Office Ordinances and Guidelines apply to pension funds that are not a "professional investor". Hence, the narrowing of what constitutes a "professional investor" under the 2013 amendments pursuant to the Bill will have the effect of expanding the scope of application of the 2012 amendments.

## Further amendments?

Despite these efforts by the regulators, another incident involving an investment management firm was recently discovered. On 26 April 2013, the regulator revoked the licence of MRI International, Inc., a US-based investment management firm. According to newspaper reports, MRI International, Inc. is suspected of mismanaging its clients' assets, and approximately JPY 100 billion may have been lost.

When the Diet passed the Bill, it also passed a supplemental resolution to the effect that, in order to prevent a recurrence of such incidents, additional regulation of asset managers (not covered by the above new regulations) should be considered.

In light of the MRI incident and the supplemental resolution, it is possible that the regulators may consider further regulation of the asset management industry. We will continue to keep an eye on developments.

*Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.*

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