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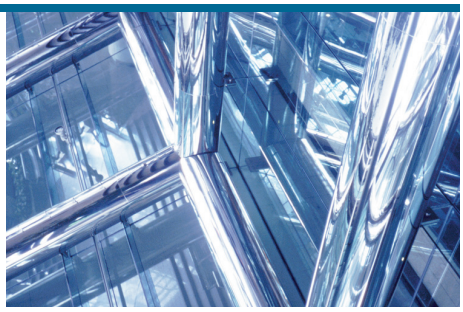

Summary of FSA Answers to Public Comments on Proposed Amendments to Asset Management Regulations as a Result of the AIJ Scandal

This Client Alert is a summary of important observations contained in the response of the Financial Services Agency of Japan (**"FSA"**) to public comments on proposed amendments to the various financial regulations of Japan in response to the AIJ scandal and is intended as a follow up to our Client Alert issued on November 19, 2012 regarding the proposed amendments to asset management regulations (**"Amendments"**) as a result of the AIJ scandal.

On December 13, 2012, the FSA issued amendments to various Cabinet Office Ordinances (*naikaku furei*) and Supervisory Guidelines (*kantoku-shishin*) regulating the asset management business in Japan and at the same time released its answers to the public comments on the proposed language of the amendments. Although the FSA revised a small portion of the proposed language of the amendments based on the public comments, there was no material change to the content of the regulations as originally proposed. Nevertheless, in some areas the FSA's answers to public comments did help clarify the FSA's position as to the meaning and intent of the amendments.

References in the text below are references to the numbered comments in the release issued by the FSA (http://www.fsa.go.jp/news/24/syouken/20121213-2/01.pdf). Please note that this Client Alert does not cover all aspects of the amendments. Please consult your adviser when you prepare to comply with the new rules.

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Disclosure Obligations of DIMs to Clients and Trust Companies/Trust Banks

(i) Amendments Related to the Pre-Execution Notification and the Management Report

As we explained in our previous Client Alert, pursuant to the Amendments, each financial instruments firm engaging in investment management business (**"DIM"**)[1] will be required to disclose the following additional information in the client notification to be furnished prior to the execution of an investment management agreement with the client (*keiyaku-teiketsumae-koufu-shomen*; the **"Pre-Execution Notification"**) (Article 96, Paragraph 1 of the Cabinet Office Ordinances concerning Financial Instruments Business (**"Business Ordinance"**)[2]:

- basic investment management policy; and
- whether the DIM is being audited by an external auditor regarding its financial status or its DIM-related business and, if so, the name of the external auditor, the scope of the external audit, and a summary of the external audit results.

If the DIM plans to make an investment in specific Target Securities (defined below), the following information will also be required to be disclosed prior to the execution of the DIM agreement (Article 96, Paragraph 2 of the Business Ordinance):

- the structure of the securities specified in Article 96(4) of the Business Ordinance ("**Target Securities**") such as investment fund, LP interests or other securities;
- the calculation method for the Net Asset Value (**"NAV"**) of the Target Securities (including investment funds);
- the frequency and the method to report the NAV to a person who has an interest in the Target Securities;
- the name, address and role of the issuer, manager, custodian and administrator (**"Fund-Related Persons"**) and, to the extent applicable, their respective personal/capital relationship with the DIM, and the capital relationship among these parties; and
- whether the fund assets are being audited by an external auditor and, if so, the name of the external auditor.

In addition, DIMs are required to disclose the following additional information in the asset management report (*unyo-houkokusho*; the "Management Report") (Article 134 of the Business Ordinance):

- changes in status in respect of managed assets during the relevant period;
- matters relating to transitions in the management of the assets;
- whether the DIM is being audited by an external auditor in respect of its financial status or its DIM-related business during the relevant period and, if so, the name of the external auditor, the scope of the external audit, and a summary of the external audit results.

In relation to these disclosure obligations, the FSA clarified that:

(i) the provision of the Pre-Execution Notification containing the above information is required only when a new DIM agreement is executed after the enforcement of the Amendments (No. 94-98);

(ii) the description of "basic investment management policy" (title to be amended to "outline of trust objectives") can be provided in general terms but must contain specific indications for the employee pension fund client in respect of the type of management that will be conducted (No. 106-109);

(iii) the scope of the external audit concerning the financial status or the DIM-related business is defined in the Guidelines (such as (i) a financial statement audit and internal control audit; or (ii) accounting auditor's audit under the Company Act) (No. 110));

(iv) only relevant portions of the audit results that are deemed reasonably important for the execution or continuation of the DIM agreement are required to be disclosed (No. 116-120);

(v) if the investment strategy of the DIM is to invest the assets of its clients into Target Securities, the identification to the client of the names of specific investment funds will not be deemed as the handling of a public offering of securities (and thus not deemed as a Type I or Type II business) as long as such activities are substantially to be undertaken in the form of a solicitation of a DIM agreement, and the DIM makes such investments based on its own investment decisions (No. 131-134, 138);

(vi) the "calculation method for NAV" needs to include (a) methods to evaluate each major asset (which must be specific enough for the client to obtain an overview of such assets) and (b) an outline of how reference prices are decided (the comments note that "using information provided by vendors" is not appropriate as the description of a "calculation method for NAV"; it is rather a reporting method for NAV) (No. 142-144);

(vii) with respect to disclosure concerning Fund-Related Persons for a foreign LPS, both the GP and the investment manager need to be identified if such investment manager is retained (No. 151);

1 Financial instruments firms engaging in an agency business for the conclusion of discretionary investment management agreements must provide the same disclosure.

2 "Frequency of investment management reports" is required to be added to the notification which is delivered upon the execution of the investment management agreement (Article 107(i)(xi) of the Business Ordinance).

(viii) Major parties who could influence the calculation and transmission of NAV should be indicated as "Fund-Related Persons" (Public Comment No. 153). Under this guidance, both the administrator and the custodian need to be mentioned as Fund-Related Persons, if applicable, although sub-custodians need not be mentioned as Fund-Related Persons (No. 152). The securities company that serves as the agent of the beneficiary must also be indicated as a Fund-Related Person (No. 153);

(ix) Accepting the public comments, FSA decided to delete the requirement for the reporting of capital relationships among Fund-Related Persons (No. 162-167); and

(x) the specification of "changes in status in respect of managed assets" needs to include at least (a) changes in status of the client's assets under management such as reference prices as of the beginning and end of the relevant period; (b) an analysis of major factors affected by such change for all asset classes which constitute a part of the client assets under management; and (c) the investment ratio into each asset class while the description of "transition of management circumstances" needs to include changes to reference prices for a reasonable period not limited to the relevant period (No. 175-178).

(ii) Providing Information to Trust Companies or Trust Banks

As also discussed in the previous Client Alert, if the DIM is delegated investment management authority by a trust company (*shintaku kaisha*) or a trust bank (*shintaku ginkou*, collectively, a **"Trust Company"**) and elects to invest into Target Securities, the DIM must ensure that a such Trust Company will directly receive NAV information for the Target Securities or otherwise confirm such data directly with the party responsible for the relevant NAV calculation.

As to a question in the public comment with respect to whether DIMs will be required to confirm that a Trust Company actually received such NAV information, FSA clarified that the DIM is required to ensure such receipt by the Trust Company at the time of a new investment (which is consistent with the language of the Business Ordinance) (No. 11-13). However, the FSA further pointed out that the FSA Guidelines require DIMs to regularly confirm that compliance with these delivery requirements is ensured after such investment (GL VI-2-2-1 (vii)-(ix)). Therefore, in practice, the DIM will be required to ensure that the NAV information of the investment fund is received or confirmed on an ongoing basis as described in the previous Client Alert.

Pursuant to the Amendments, the beneficiary interests in the investment trust investing only into listed securities, government bonds, interests in market derivative transactions, deposits etc. will be excluded from the definition of Target Securities that are subject to the above-mentioned requirements. In addition, based on the public comments, the FSA excludes from Target Securities (and not subject to the above requirements) beneficiary interests in a baby fund which invests in a mother fund which invests only in these financial products (No. 20-21).

In addition, the FSA provided certain further clarifications with respect to information that must be provided to investors, etc. as follows:

(i) the NAV information should be the NAV most recently available (not necessarily the NAV as of the day of periodic notification) (No 31-32);

(ii) if an administrator is the party responsible for the NAV calculation, the Trust Company can meet the requirement to ensure direct confirmation of the NAV by making a call or sending an e-mail to the administrator or checking the website maintained by an administrator; however, provision by information vendors will not be sufficient because usually these vendors are not the party responsible for the NAV calculation (No. 34, 36); and

(iii) a Trust Company will not be required to confirm the authenticity of the audit reports, etc. provided to the Trust Company pursuant to the requirements above, unless a suspicion exists that such audit reports, etc. are forged (No. 51).

External Audit of the DIM's Operation and Target Securities

As discussed above, in its Pre-Execution Notification, a DIM is required to disclose whether such DIM is subject to an external audit of its business operations and financial status and, if so, the scope and results of such external audit. Additionally, if the Trust Company is acting as the trustee for the assets of a client, and if the DIM is acting as an investment manager appointed by such Trust Company, the DIM must also ensure that the Target Securities (i.e., the interests in the investment fund) are audited.

In response to questions posed in the public comments, the FSA clarified that an audit performed by a group company is not an "external audit" (No. 125, 126) for purposes of the Amendments. Also, even if the DIM is a subsidiary of a parent company that is audited by an auditing company, and the scope of the audit for the parent company includes such DIM, such audit of the DIM is not an "external audit" (No. 127).

Also, the FSA added that if the DIM is involved in the appointment of an external auditor of the fund, the DIM must ensure the independence and effectiveness of such external audit of the fund (VI-2-2-1(viii), No.70-71).

In addition, the FSA clarified that if the Target Securities are held by a "fund-of-funds" type fund, only the fund-of-funds is required to be audited and the underlying funds of the fund-of-funds are not required to be audited (No.56-59).

Other Restrictions With Respect to Employee Pension Funds

(i) Prohibition on Executing Trades Instructed by an Employee Pension Fund

As previously discussed, the DIM is prohibited from accepting instructions concerning a specific trade issued by an employee pension fund except where the DIM subscribes the fund's assets into an investment fund managed by an affiliate of the DIM. Also, a DIM is prohibited from engaging in any action that could be deemed to constitute solicitation of investment (securities) products, or requiring its employee pension fund client to provide the DIM with a specific trade instruction for such investments.

In relation to such prohibition, FSA explained that:

(i) such "specific trade instruction" includes a case where an employee pension fund participates in the investment decision (No. 238) but does not include a case where an employee pension fund instructs the DIM to execute specific transactions based on factors different from investment decisions related to the value of securities, (such as, for example, not to invest into issuers that have been involved in scandals (No. 239)).

(ii) the exception with respect to the investment fund managed by an affiliate of the DIM is based on the theory that investment in such fund will be determined by the DIM or its affiliate, not by the employee pension fund (No. 247-248).

The FSA also noted that designating or providing an explanation with respect to a specific investment fund in the Pre-Execution Notification will not be considered a violation of these prohibitions (and should not constitute solicitation of such improper instruction) as long as such provision is made for clarification purposes and is not binding on the DIM (No. 240, 244, 249, 251). The FSA further clarified that such prohibition does not restrict DIMs from visiting employee pension fund clients accompanied by an affiliate fund manager to explain the performance of the fund that the DIM has invested in under its DIM authority as long as the DIM and the affiliate fund manager do not solicit products created by the affiliate fund manager and do not solicit specific trade instructions from the employee pension fund client (No. 252).

(ii) Diversification Requirements for a DIM Managing Employee Pension Fund Assets

As discussed in the previous Client Alert, employee pension funds are generally required to diversify their investments, and DIMs, when becoming aware that an employee pension fund is not in compliance with this requirement, must notify the employee pension fund client of any potential violation of this rule.

FSA clarified that:

(i) DIMs will not be required to actively investigate compliance with the above diversification obligations for new or existing employee pension fund clients (although the FSA reserved on whether the DIM would be meeting its fiduciary duty if it failed to check such matters). Nevertheless, the DIM will be required to notify its client if it learns of such failure to diversify (regardless of how the DIM comes to recognize such potential violations). For example, if the DIM discovers that a pension fund's investment guidelines are clearly not consistent with its basic investment management policy or that following the existing guidelines is questionable (such as investing all assets into high risk products), the DIM must so notify the client (No. 202-206, 217-218, 220);

(ii) if it is not possible to terminate, or if there is good reason not to terminate, a DIM will not be required to terminate its DIM agreements with employee pension fund clients, even after a notification to the employee pension fund client of a potential violation of the diversification obligation and discussion with the such employee pension fund client concerning the same (i.e., such termination is one of the possibilities that a DIM should consider in such a case) (No. 226).

Effective Date

The amendments were promulgated on December 13, 2012.

The effective date of the amendments regarding maintenance of checking systems by DIMs, etc. is April 1, 2013. This portion of the amendments includes: (i) prohibitions on executing trades specifically instructed by employee pension fund clients, (ii) consolidation of the system for making explanations of investment management services (e.g., risks etc.) to an employee pension fund client based on the experience and knowledge of the client, etc., and (iii) notification to employee pension fund clients if the DIM recognizes potential risks in violation of the investment diversification obligation.

The effective date of the other amendments is July 1, 2013.