

# ClientAlert

## Tokyo Financial Services Group

November 2012

### The Proposed Amendments to Asset Management Regulations as a Result of the AIJ Scandal

This Client Alert contains a summary of the recent released 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 September 11, 2012](#) regarding the actions proposed by the Financial Services Agency of Japan ("FSA") to prevent the recurrence of the AIJ Scandal.

On October 12, 2012, the FSA released the proposed language of amendments to various Cabinet Office Ordinances (*naikaku furei*) and the Supervisory Guidelines (*kantoku-shishin*) regulating the asset management business in Japan. The proposed changes to the Cabinet Office Ordinances and Supervisory Guidelines appear to be consistent with the proposed action plan that had been previously issued by the FSA in September. The FSA is also still considering the manner by which it will implement the amendments to the various laws which were proposed in its action plan.

#### DIM's Disclosure Obligations to Clients and Trust Companies/Trust Banks

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

For the purpose of providing detailed information regarding target assets to clients in advance, the new proposed amendments to the Cabinet Office Ordinances increase the disclosure obligations of financial instruments firms engaging in an investment management business ("DIMs"). Much of this additional disclosure is made through the additional reporting requirements that a DIM must make in relation to: (i) the client notification to be made prior to the execution of the investment management agreement (*keiyaku-teiketsumae-koufu-shomen*, the "Pre-Execution Notification"); and (ii) the asset management report (*unyo-houkokusho*, the "Management Report").



If you have questions or comments about this Client Alert, please contact:

##### Christopher Wells

Partner, Tokyo  
+ 81 3 6384 3100  
cwells@whitecase.com

##### Koichiro Ohashi

Partner, Tokyo  
+ 81 3 6384 3151  
kohashi@whitecase.com

##### Norifusa Hashimoto

Partner, Tokyo  
+ 81 3 6384 3208  
nhashimoto@whitecase.com

##### Tomoko Fuminaga

Partner, Tokyo  
+ 81 3 6384 3224  
tfuminaga@whitecase.com

White & Case LLP  
White & Case Law Offices  
(Registered Association)  
Marunouchi Trust Tower Main 26th Floor  
1-8-3 Marunouchi  
Chiyoda-ku, Tokyo 100-0005  
Japan  
+ 81 3 6384 3300



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Services Group

Under the proposed amendment to the Cabinet Office Ordinance Concerning Financial Instruments Business (the “**Business Ordinance**”), if the investment strategy of the DIM is to invest the assets of its client into a specific collective investment vehicle (including domestic/foreign unit trusts, investment corporations and limited partnerships, “**Investment Fund**”), the DIM is required to disclose the following additional information:

- the structure of the target Investment Fund;
- the calculation method for Net Asset Value (“**NAV**”) of the target Investment Fund;
- the frequency and the method by which the Investment Fund will issue its report which sets forth the NAV of the Investment Fund;
- the name, the address and the role of the issuer, the manager, the custodian and administrator, and to the extent applicable, their respective personal/capital relationship with the DIM, and the capital relationship among these parties; and
- whether the Investment Fund is being audited by an external auditor and, if so, the name of the external auditor.

With respect to the Management Report, the DIM is currently required to provide such Management Report to all of its clients on at least a semi-annually basis. However, under the proposed amendment to the Business Ordinance, if the client of the DIM is an employee pension fund, the DIM will be required to provide such Management Report on a quarterly basis. Furthermore, the following additional information will be required to be included in the Management Report: (a) a summary of the method for the management of the assets; (b) changes in status in respect of the managed assets; and (c) whether the target investments of the DIM are subject to an external audit during the relevant period and, if so, the name of the external auditor, the scope of the external audit, and a summary of the audit results.

It should be noted that if the client of the DIM is a professional investor (*tokutei toushika*), the DIM is not required to deliver the Pre-Execution Notice or to issue the Management Reports. However, related to this point, it should be noted that under the proposed amendment to the Supervision Guidelines for Financial Instruments Business Dealers (“**FSA Guidelines**”), the DIM will be required to make a (proper and prudent) judgment with respect to the election by a non-professional investor to be treated as a professional investor in consideration of the knowledge, experience, amount of assets and investment purpose of the client.

## (ii) Providing Information to Trust Companies or Trust Banks

Under the proposed amendment to the Business Ordinance, if a DIM has been delegated investment management authority by a trust company (*shintaku kaisha*) or a trust bank (*shintaku ginkou*, collectively, a “**Trust Company**”) and such DIM elects to invest into an Investment Fund, prior to making such investment, the DIM must ensure that such Trust Company will receive the NAV information of such Investment Fund at least every six months (if the client is an employees’ pension fund, at least every three months) or otherwise confirm the NAV information of the target Investment Fund directly from the party responsible for the relevant NAV calculation of the Investment Fund. Also, the DIM must ensure that this same NAV information of the Investment Fund will be received or confirmed on an ongoing basis.

Furthermore, under the proposed amendment to the Business Ordinance, if the Trust Company is acting as the trustee for the assets of the client, the DIM shall also, without delay, send a separate notice to such Trust Company after delivering the Management Report to the client to provide information on the issuer, volume and the NAV of the target Investment Fund. Under the proposed amendment to the Cabinet Office Ordinance with respect to the Trust Business Act (the “**Trust Business Act Cabinet Office Ordinance**”), if the Trust Company receives such information, the Trust Company is required to have a system sufficient to check whether such information is accurate and deliver the results of such check to the client.

## External Audit for the DIM’s Operation and Target Investment Funds

Under the new proposed amendments to the Business Ordinance, 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, under the proposed amendment to the Business Ordinance, if the Trust Company is acting as the trustee for the assets of the client and if the DIM is acting as the investment manager of a Trust Company, in addition to the arrangements that the DIM must make with respect to the reporting of the NAV of the Investment Fund to the Trust Company (as discussed above), the DIM must ensure that: (a) the target Investment Fund is audited; and (b) the Trust Company may obtain the audit report directly from the auditor or indirectly through a person other than the manager of the Investment Fund or its affiliates.

In addition, the DIM shall be required to provide a detailed disclosure regarding the external audit (if any) performed on its financial statements and Target Investment Funds in its annual business report.

## Other Restrictions with respect to Employees' Pension Funds

In addition to the various disclosure obligations and restrictions above, under the proposed amendments, the following restrictions or prohibitions will apply to a DIM that manages the assets of a Japanese employees' pension fund:

### (i) Prohibition on Executing Trades Instructed by the Employees' Pension Fund

Under the proposed amendment to the Business Ordinance, where an employees' pension fund has appointed a DIM to act as its investment manager with respect to such employees' pension fund assets, the DIM is prohibited from accepting instructions on a specific trade from the employees' pension fund as employee pension funds are required to delegate all investment authority to a DIM under the Employees' Pension Fund Ordinance. However, it should be noted that the foregoing provision is not applicable in certain circumstances, including where the employees' pension fund is issuing an instruction for the DIM to subscribe the fund's assets into an Investment Fund managed by an affiliate of the DIM.

Furthermore, under the proposed revisions to the FSA Guidelines, a DIM is prohibited from engaging in any action that could be deemed to constitute solicitation of products or inducing its employees' pension fund client to provide the DIM with a specific trade instruction. However, if the DIM is providing a description or explanation with respect to a specific Investment Fund which is set forth in the Pre-Execution Notice, and the investment management mandate contemplates the investment into such specific Investment Fund, the foregoing prohibition will not apply.

### (ii) Prohibition on the Marketing of Products of the DIM to an Employees' Pension Fund

Under the new FSA Guidelines, during visits to a DIM's employees pension fund client regarding the performance of an existing investment management mandate, if the DIM is accompanied by another financial instruments dealer, the DIM must not engage in any activity that would solicit or induce an instruction from the employee pension fund to invest in an Investment Fund that has been sponsored by the other financial instruments dealer (including any activity by the DIM which may be deemed to be securities marketing in substance).

### (iii) Appropriate Explanation of Investment Management Services to an Employees' Pension Fund

Under the proposed amendment to the Business Ordinance, the DIM will be required to have adopted a system which is sufficient for such DIM to make an appropriate explanation regarding the estimated profits of the contemplated investment strategy, the risks, etc., in consideration of the level of sophistication of the client (i.e., knowledge, experience, asset status, purpose of the agreement).

### (iv) Diversification Requirements for a DIM Managing Employees' Pension Fund Assets

Employees' pension funds are generally required to diversify the target of their investments under the Employees' Pension Fund Insurance Act. If a DIM becomes aware that there is a possibility that its employees' pension fund client may be in violation of such diversification obligation, under the proposed amendment to the Business Ordinance and FSA Guidelines, the DIM must notify to employees' pension fund regarding such potential violation. If the DIM believes that the employees' pension fund is still in violation of such diversification duty even subsequent to giving such notice, the DIM must have discussions with the employee pension fund regarding potential solutions (including changes the investment mandate of the DIM). If, even after such discussion, the DIM is of the view that the employee pension fund is still not in compliance with its diversification duty, the DIM should consider terminating the investment management agreement with such employee pension fund client.

## Effective Date

Please note that at the date of this Alert, the effective date of the amendments has not been released by the FSA and there is a possibility that the language of the proposed amendments may change.

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