



Outline of the Regulatory Review on Investment Trust and J-REITs

PROVISIONAL TRANSLATION

December 2012

Introduction

- In June 2010, the Cabinet decided to comprehensively review the Law on Investment Trusts and Investment Corporations* by 2013.
** The law stipulates regulations for investment trust funds and J-REITs.*
- In December 2010, JFSA released an action plan for revitalizing the financial markets and the industry, which stated its commitment to the review above.
- JFSA conducted an internal pre-review, following the release of the action plan, by interviewing the various stake holders in the market, financial institutions, investors, accountants, financial experts, law firms, etc.
- In January 2012, the Minister of Financial Services requested the Financial System Council* to make a comprehensive review of the relevant Law by the end of this year and give advice on a possible amendment that is scheduled to be submitted to the Diet in early 2013.

** An advisory body to the minister concerning financial regulation updates*

Points of the review

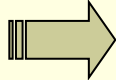
- The points of issues that the minister requested the review to address:
 - Concerning the investment trusts;
 - *Possible deregulations in response to international discussions about regulatory reforms and Japanese economic and social changes*
 - *Possible measures to establish an appropriate supply system of products for ordinary individual investors*
 - Concerning the J-REITs;
 - *Possible measures for a more stable financial structure of REITs, including the diversification of capitalization methods*
 - *Possible measures for more transparent operations and trades of REITs, so as to increase investor confidence*
- A working group for the review was formed under the Financial System Council
 - Members: 7 academics, 3 lawyers, 2 think-tank members, an analyst, an accountant, 2 investor representatives, an industry representative, and TSE
 - Relevant industries joined the discussion as observers
- On December 12, 2012, the final report was released after the 13 physical meetings since April 2012.





*Outline of the Final Report on the
Regulatory Review Concerning the
Investment Trust Funds*

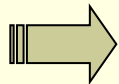
Analysis of the current situation of investment trust market (1)

- The current market size of Japanese investment trust funds is not sufficient for paying all the expenses associated with the operation and management of funds with the management fee (trust remunerations) based on the funds outstanding. This makes the up-front sales charges more important for financial institutions.
 - Sales charges of investment trusts also have become important where traditional profit sources of financial institutions have declined.
 - In these circumstances, new products have flooded the retail market.
 - The demand of individual investors is not sufficiently reflected in the process of fund design and sales.
-  ➤ The increasing number of funds and the accompanying shrinking of each fund is reducing the earnings and expenses of fund management, which again tend to induce new products to earn new sales fees.

A more customer-oriented approach is necessary for the fund design and sales.
It is also necessary to improve the efficiency of the fund management.

Analysis of the current situation of investment trust market (2)

- As the current Japanese stock price and interest rate has made it difficult to earn a profit with traditional investment style, the prevailing trend of retail funds is investment overseas and the incorporation of multiple profit engines into a product. The trend of overseas investment has been accompanied by the increasing number of fund-of-funds type retail funds.
- For investors who wish to receive periodic income similar to deposit interest, funds with a high-frequency dividends policy are aggressively sold.
 - Products tend to be complicated and different risks are being combined.
 - It tends to be difficult to understand the total return of a fund



It is necessary to enhance explanations of characteristics of products and risks at the time of the sale, as well as to make a total return of a fund more understandable.

It is also worthwhile to consider the regulation to limit non-linear types of risk.

Analysis of the current situation of investment trust market (3)

- The current main investors in the investment trust fund market consist of the cluster of the retiring and retired generations, which reflects the uneven money distribution among generations and the financial anxiety for the rest of their life among this generation.
- ➔ While this generation is expected to decrease due to Japanese demographical change, investment trust funds need to play the role of accumulating the assets of the working generation for its future.

It is necessary for the relevant industries to promote investment trust funds for the working generation with a clear purpose of periodic, small-amount investments.



Major measures to improve the efficiency of fund management

- Deregulating beneficiaries' approval on contract changes and mergers
 - The current regulation requires beneficiaries' approval prior to the amendment of a trust agreement of a fund if the product characteristics will change after the agreement amendment. In the case of a merger, the regulation also requires such approvals by the beneficiaries from both merging funds.
 - There are some agreements that this system tends to hinder flexible investment policy change as well as mergers between inefficient funds.
 - The final report recommends to create an exception to this approval in the following cases:
 - *For a trust agreement amendment, the approval will not be necessary if*
 - *the amendment is for the beneficiaries' interest, or*
 - *it is a clerical change and not against the beneficiaries' interest, or*
 - *it is necessary for compliance with a regulatory change.*
 - *For the merger, the approval by the beneficiaries of the fund satisfying the following will not be necessary;*
 - *the asset of a fund composed after the proposed merger will be in line with the investment policy of the fund in question, and*
 - *The asset size of the fund in question is sufficiently larger than the other merging fund, and*
 - *The change of trust agreement will be limited within the scope of the exceptional cases above.*
- Expanding the exceptions of prohibition of trade between funds
- Partial lifting of the ban on depositing the mixture of securities and money to ETF

Major measures to establish an appropriate supply system of products for ordinary individual investors (1)

- Two-step approach of a periodic investment report to investors
 - Periodic investment reports, which update investors on a fund's operation and performance, are sometime too long, too detailed, and too technical to understand by average individual investors.
 - The final report recommends to create a simple report containing key information written in plain (Japanese) language that should be delivered to each investor of the fund, and to post the current report on the asset management company's website so that the investors who would like to know the details can access it at their convenience.

- Notification of a total return to investors
 - Although the dividend and net asset value in each financial period are reported to investors periodically, it is getting difficult to understand the total return, including the dividend, as the high-frequency dividend type of funds has emerged.
 - The final report recommends to introduce, as a requirement for all financial institutions, a notification of total returns that shows clearly all investors' positions of total gain or loss incorporating the historical results of the paid dividend and fluctuation of net asset value of their investment.

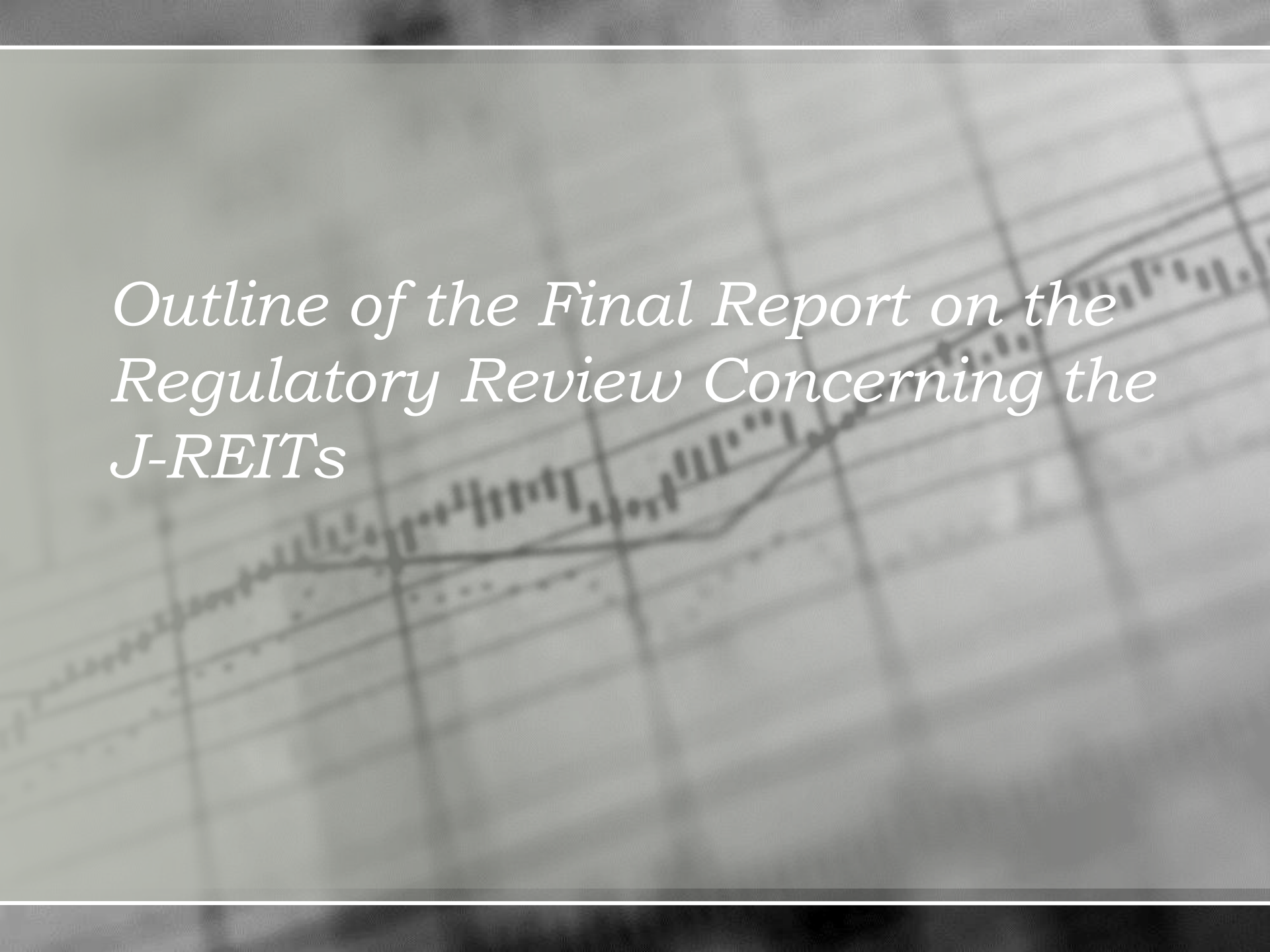
Major measures to establish an appropriate supply system of products for ordinary individual investors (2)

■ Enhancing risk disclosure

- Although the current regulation requires to describe the risk contained in the fund in its prospectus, the qualitative description can only attain the awareness of the possibility of loss. It became more important to understand the relative riskiness of the fund investors' purchase in order to make a rational investment decision as products are getting more complex and associated risks are multiple.
- The final report recommends to enhance the risk disclosure in a more understandable manner, making it possible to quantitatively understand and compare funds.

■ Introducing limits over certain types of non-linear risk

- Average individual investors may not be aware of the complex risks only through disclosure, and a loss would happen non-linearly if such risks were not mitigated and dispersed sufficiently.
- The final report recommends the following measures:
 - *Dispersing credit risk in a quantitative manner,*
 - *Unifying the calculation methods of derivative risks that should be limited within the asset value of a fund by the current regulation,*
 - *Applying the same rule to foreign funds that are directly sold in the Japanese market or incorporated in fund-of-funds type of investment trust funds sold in the Japanese market.*



*Outline of the Final Report on the
Regulatory Review Concerning the
J-REITs*

Analysis on the current situation on J-REIT market (1)

- J-REITs have been increasing in importance as financial products in the Japanese market since their creation 10 years ago.
- At the same time, they have been influenced more and more by financial market fluctuation.
- The global financial turmoil after the Lehman Shock revealed J-REITs' shortcomings in terms of their financial structure.
 - *Refinance risk associated with their highly leveraged operation was realized in the market turmoil.*
 - *If that risk arose at the same time as the current systemic limitation of capitalization methods, the situation would tend to be worse.*
 - *REIT prices tend to be more volatile although asset prices and cash flows are stable, which hampers the sentiments of those who have sought medium risk & medium return.*
- It is necessary to introduce additional measures to stabilize the financial constitution of J-REITs.

Analysis on the current situation on J-REIT market (2)

- It is also necessary to improve the transparency of the operation and trades associated with J-REITs.
 - The sponsor of a J-REIT plays the important role in the management of the J-REIT, in terms of human resources, skills, supply of real estate, and credit complementation.
 - On the other hand, there is a discussion among investors on the concerns about conflicts of interest between sponsors and J-REITs.



Major measures to stabilize the financial base of J-REITs

- The report recommends to introduce the following options to stabilize the financial constitution of J-REITs:
 - Rights offerings
 - Capital reduction
 - Stock buyback



Major measures to improve transparency

- The report refers to the investors' concern about the current measure to prevent conflicts of interest between J-REITs and sponsors.
 - Currently, if an asset management company to which a J-REIT outsources its investment operation enters a transaction with its interested parties, the company should report it to the J-REIT.
 - The report, however, is ex-post and thus this measure may not be sufficient to prevent the company from performing a transaction that damages investors' interests.
- For this issue, the report recommends to introduce the following measures;
 - Reinforcing the supervising function of executive committees of a J-REIT,
 - *Introducing the requirement of ex-ante consent by the executive committee of a J-REIT on the trade conducted by its asset management company on behalf of the J-REIT and the sponsor*
 - Disclosure of the detailed information based on which the purchase price is calculated
- The report also recommends to include J-REITs under the current insider trading regulation.
 - Currently, J-REITs are outside the insider trading regulation.
 - It is because, when J-REITs were introduced, their prices were expected to be formed on the basis of their net asset values and thus a transaction taking advantage of unrevealed information would not be beneficial.

Other measures

- Change of conditions for a short-form merger
 - Current
 - *Possible number of shares stipulated in the articles of association of the surviving J-REIT > Number of shares assigned to the shareholders of the J-REIT extinguished in the merger*
 - Possible amendment
 - *Actual number of shares of the surviving J-REIT before the merger > Number of shares assigned to the shareholders of the J-REIT extinguished in the merger*
- Removing impediments to investments in real estate abroad
 - Currently J-REITs cannot obtain more than 50% of the voting rights of another corporation.
 - That regulation hinders J-REITs from investing in real estate abroad under the SPC scheme.
- Other measures for efficient operation

