

Working Group on Review of Investment Trust and Investment Corporation Regulation

Final Report

1. Introduction

(1) Historical background

The Act on Investment Trusts and Investment Corporations (hereinafter referred to as the “Investment Trust Act”) was established in 1951 as the “Securities Investment Trust Act,” which instituted a framework for the investment of funds collected from investors in securities. Then, amendments were made: the amendment to set out settlors’ duty of loyalty to beneficiaries (in 1967) , the amendment to change from the approval system into a registration system of individual basic terms and conditions for the setting up of funds, and to establish systems of investment corporations (in 1998). In the amendment of 2000, when the Act was renamed to the current name, the establishment of real estate investment trust (J-REIT) was enabled, expanding the main subject of investment to include real estate, etc.

After that, there were no major amendments. However, in “the New Growth Strategy” approved by the Cabinet in June 2010, “the Action Plan for the New Growth Strategy” published in December of the same year and “the Comprehensive Strategy for the Rebirth of Japan” approved by the Cabinet in July of this year, it was decided to review investment trust and investment corporation regulation and to develop and implement new regulatory systems by the fiscal year 2013.

In order to provide suitable investment opportunities to various investors, it is important to develop an environment which enables people to effectively utilize financial assets, take suitable risks corresponding to their asset size and knowledge, and obtain return. In addition, the asset investment management business is one of the core businesses that plays a role of facilitating the future development of financial/capital markets and the growth of financial assets held by individuals. Asset management companies are strongly required to enhance their ability to manage assets and provide proper asset management services to customers.

Given such situations, in January of this year, the Financial System Council was requested to consider the review of investment trust and investment corporation regulation from the following perspectives:

- Investment Trusts: Making the regulation flexible to suit trends in international rules and changes in social and economic circumstances, and ensuring the supply of appropriate products in consideration of ordinary investors.

- Investment Corporations: Improvement of the stability of financial foundation, including diversification of financing methods; assurance of management that can be better trusted by investors and of the transparency of transactions.

(2) History, etc. of discussions held at the Working Group

In response to the above-mentioned request, the Financial System Council established the Working Group on Review of Investment Trust and Investment Corporation Regulation (hereinafter referred to as the “Working Group”) and the Working Group began its deliberations March of this year.

In July of this year, a summary was compiled of discussions held during the eight sessions of deliberations held until then and also an interim summary of issues was drawn up for the purpose of confirming the later policy. At the meetings held in and after September of this year, based on the interim summary of issues, deliberations were held:

- to specifically discuss matters for continued consideration; and
- to consider matters for administrative consideration at the secretariat in accordance with the direction provided in the interim summary of issues, and mainly receive the results of such consideration.

In this Final Report, based on the deliberations during the total of 13 sessions held until now, the basic concept of review of investment trust and investment corporation regulation is compiled and presented.

2. Investment Trust Regulation

(1) Current state of Japanese investment trusts and the direction of actions

The following points were pointed out by the Working Group regarding the current state of Japanese investment trusts.

- (i) Environment surrounding the current investment trust market and economic activities, etc. conducted thereunder

Some pointed out that since the quantitative increase of investment trust is underway, trust fees charged on the balance of investment trusts does not cover the costs at its current size, and therefore a greater focus is placed on the sales commissions. For financial institutions, which are suffering from the poor performance of traditional sources of income such as stock trading commissions and the profit margin of interest rate, the investment trust sales commissions have become an important source of income. In addition, sales companies have fostered relationships with many customers. In such circumstances, a succession of new products, which are designed to appeal to the appetites of investors, have been developed and sold based on the new themes reflecting market trends.

Furthermore, the prolonged slumping stock prices and low interest rate environment has made it difficult to use traditional investment methods to gain high returns. In this environment, aiming to meet the needs of investors that seek to realize higher returns, more and more products are being developed that invest primarily in foreign assets, that combine multiple sources of income, and that have high frequency and high volume of dividends which are designed to appeal to investors who desire periodic income payments like deposit interest, etc. Regarding the investment in foreign assets in which the ratio of investment is increasing in recent years, since the investment is dependent on the ability of foreign investment management companies and the infrastructures for investment trust operations in relevant countries, such investments are often made through outsourced foreign investment management companies or made in funds managed by foreign investment management companies (so called “funds of funds”). This realizes the diversification of assets, while, as some pointed out, it is one of the reasons for increased complexity of products.

The main customers in the investment trust market, to whom these products are offered, are of the pre- and post-retirement generations. One of the reasons for this is considered that, in Japan, surplus funds are disproportionately held by the pre- and post-retirement generations, and that there are growing concerns about the uncertainty of post-retirement life.

(ii) Effects brought about as a result of the above and the direction of actions

Firstly, some pointed out that, in an environment where sales companies, whose important source of income is sales commissions, have a major influence on the supply of products, problems such as shorter investment periods may arise, and the asset management needs of investors are not necessarily reflected in the product development and sales. For this reason, in the development and sales of investment trust products, it is even more required to have consumer (investors) oriented perspectives. For example, it is considered important to exercise the consulting function based on the perspective of asset accumulation taking into account of customers’ life and money planning.

It was also pointed out that, in order to ensure that incentives of asset management companies and sales companies become more customer oriented, there is a need to provide information to customers such as career of investment managers and compensation structure and a need for a shift from a transaction-based compensation structure to a balance-based compensation structure. There were various opinions on these things; however, in any case, instead of applying regulations across the board, it is more desirable to encourage asset management companies and sales companies to voluntarily take such initiatives from the perspective of differentiating themselves from competitors. It is also expected that asset management companies strengthen their ability to develop products and to manage investment in domestic and foreign assets to meet the needs of investors.

Secondly, since new products are launched one after another, the number of investment trusts has become too many and the size of each investment trust has remained small, resulting in higher costs than fee income for many trusts. It is necessary to consider initiatives to improve the efficiency of the investment trust operations. In such consideration, if there are industry practices, etc. that lead to the growth of the number of small-sized investment trusts, the revision of such practices should be discussed as necessary, taking into consideration the situations in other countries.

Thirdly, while the ratio of investment in foreign assets is increasing, products and their associated risks are becoming more complex. As a result, fee rates for investment trusts are on a rising trend. In addition, due to the growing popularity of products with a high frequency of dividends which includes a repayment of principal, it has become difficult to assess the overall profit and loss. There should be discussions regarding efforts to further improve the explanation of the nature of products and associated risks at the time of purchase and regarding the development of a mechanism to enable investors to clearly understand the overall profit or loss after the beginning of investment. It is also worth discussing as to whether there should be any certain pre-specified limitations regarding risks that may occur suddenly or irregularly regardless of the full provision of such explanations.

Fourthly, since the pre- and post-retirement generations, the main customers in the investment trust market, are forecast to decrease in size in the future, in order to achieve the sustainable growth, the market should be seen not only as one for the investment of surplus funds, but also one for the asset accumulation. With the decreasing birthrate and aging of the population, it will become more important to offer investment trust products that allow small amount of investment for people of working age as they prepare for post-retirement years. To address these issues, for the promotion of investment trust among people of working age, it is desired that, for example, the industry takes initiatives such as a promotion of the installment investment clearly specified purpose and aggressively takes advantage of the ETF investment. It is also desired that there will be discussions on the role of the defined-contribution pension in the investment trust market.

The issues pointed out above, in many cases, should be basically addressed through the voluntary efforts by the relevant industries across all business sectors, while seeking opinions from investors and market participants. Especially, in order to ensure sound and appropriate operations of the investment trust by asset management companies, asset management companies and trustee companies, who have trustee liabilities to investors and beneficiaries, need to ensure proper operations, since much cannot be expected from the governance through monitoring by investors and beneficiaries. It is also necessary for authorities to enforce

regulations and conduct appropriate inspections and supervision. Furthermore, voluntary monitoring carried out primarily by the relevant industries is also effective. To be specific, it is desired that sound and appropriate operations of the investment trust is ensured through a variety of channels; for example, the Investment Trusts Association collects opinions and thoughts about the investment trust operations more widely from investors and properly share them among asset management companies.

(2) Flexibilization of the regulation to suit the trend of international rules and changes in social and economic circumstances

(i) Revision of the beneficiaries' written resolution system for the efficient investment trust operations

Currently, when making significant changes to the content of the basic terms and conditions of the investment trust or implementing a consolidation of investment trust, it is provided that written resolutions by beneficiaries of the relevant investment trust are required. However, in cases of publically offered investment trusts which have many beneficiaries, the implementation of the written resolution system is practically difficult; and some pointed out that it hinders consolidations, etc. Therefore, the following revisions could be considered.

(a) Revision of the scope of changes to the basic terms and conditions that requires beneficiaries' written resolutions

Currently, it is provided that "loss of identification as a product" is a "significant change to the content" that requires written resolutions by beneficiaries. In practice, the said provision is conservatively interpreted to mean that any changes are ones that lead to the loss of identification as a product, unless the change is only a matter of formality; and as a result, the scope requiring written resolutions is considered wide. It was pointed out that this hinders flexible operations of investment trusts, or that the description of asset management policy tends to cover a wide range from the beginning to avoid later amendments to the basic terms and conditions.

Regarding this point, it should be clarified that, including under the laws and regulations, there can be changes of the basic terms and conditions that do not require written resolutions, even when the change is not a matter of formality, by specifying that only "changes to the basic nature of the product" shall fall under the category of the "significant change to the content." And then, while paying attention to the protection of beneficiaries, the following changes shall be defined as ones that do not change the basic nature of the product; and it is appropriate to specify that such changes to the basic terms and conditions do not require written resolutions.

- Changes that contribute to the interests of beneficiaries
- Changes that are in administrative matters and neutral to the interests of beneficiaries
- Changes that are compulsory in order to be compliant with amended laws and regulations

From the above-mentioned perspectives, it is appropriate in the future to specifically define changes that are considered do not require written resolutions.

(b) Revision of the consolidation procedures that require written resolutions

Currently, it is provided that any consolidation of investment trusts requires written resolutions by beneficiaries on both sides of investment trust. It was pointed out that this causes small and inefficient investment trusts to remain in the market, which in turn increases the cost ratio and damage the interests of beneficiaries. From the perspective of promoting the consolidation of investment trusts, it is appropriate not to require written resolutions for those consolidations that do not change the “basic nature of product” before and after the consolidation. Then, while paying attention to the protection of beneficiaries, it is appropriate to specify that, when all of the following specific requirements are met, the consolidation shall be considered to make no changes to the “basic nature of product” and do not require written resolutions.

- Assets that would be included in the trust property after the consolidation of trusts are not deemed to violate the investment policy described in the basic terms and conditions of the pre-consolidation investment trust.
- The ratio of net assets of the investment trust to that of the other investment trust is more than certain value (provided, however, that in cases where the content of the trust property is substantially the same, such as in the case of consolidation between the investment trusts that are linked to the same index, the ratio is not required to be more than certain value).
- When the two basic terms and conditions of the investment trusts of before and after the consolidation are compared, the substantial changes are limited to those that “contribute to the interests of beneficiaries,” those that “are in administrative matters and neutral to the interests of beneficiaries” or those that “are compulsory in order to remain compliant with laws and regulations.”

(c) Abolishment of the requirement on the number of beneficiaries

Currently, in accordance with the provision in the Trust Act, it is provided that written resolutions shall be adopted by a more than two-thirds majority of the voting rights of at least half of all beneficiaries who may exercise voting rights (requirement on the number of beneficiaries). Regarding this, in consideration of the facts that, the personalities of beneficiaries have limited impact in the investment trust, and that the equality of the content of the beneficial interest is secured, it is appropriate to abolish the requirement on the number of beneficiaries from the perspective of promoting the revision concerning the changes to the basic terms and conditions and concerning the consolidation procedures.

(d) Revision of the system for dissenting beneficiaries’ demands for the purchase of their beneficial interest

Currently, it is provided that a beneficiary who has opposed written resolutions is entitled to

demand that the trustee purchase his/her beneficial interest. However, in the case of the open-end type investment trust, of which the net asset value is calculated every day, it may be redeemed at that value at any time; and a beneficiary may request for cancellation and receive redemption money that is calculated based on the net asset value as of the date of cancellation. Therefore, in cases of such investment trusts, as dissenting beneficiaries would not suffer much detriment without the opportunity to collect the invested capital provided through the grant of the right to demand for the purchase of their beneficial interest, it is appropriate not to apply the system.

(ii) Allowing multiple compensation structures, etc. in one investment trust

Currently, it is required that the beneficial interest in an investment trust shall be divided up equally, and not only the asset management policy but also the compensation structure, etc. must be the same for all beneficiaries. As a result, for example, even in cases of arranging, under the same asset management policy, products that are different only in compensation structures, they have to be separate investment trusts. Some pointed out that it is not necessarily efficient.

On the other hand, in cases of providing, in the same investment trust, for multiple classes of beneficial interests, the content of which is not equal, for example, in the compensation structure or as to whether hedged or not, it is necessary, from the perspective of protecting beneficiaries, to consider the introduction of new ways to align interests, such as a written resolution system, which is implemented for different class of beneficiaries.

Some pointed out that introducing such a system would increase costs for the operations of investment trusts. At this point, instead of introducing the system immediately, it is required to continue to make efforts to understand specific needs, and discuss the above-mentioned issues.

(iii) Clarification of regulations on outsourcing

Currently, regarding the entrustment with the authority to give instructions for investment by a settlor company of an investment trust, there is a provision defining the scope, etc. of entities to which asset management is entrusted. On the other hand, it was pointed out that, since there is no express provision regarding business activities other than the giving of instructions for investment, it is unclear about whether entrustment is allowed. It is appropriate to clarify, in one way or another, that entrustment with the authority other than to give instructions for investment is allowed, so that the entrustment that would improve the operational efficiency will not be hindered.

(iv) Clarification of the acceptable scope of transactions between investment trust funds

Currently, transactions between investment trust funds are, as a rule, prohibited; however, only

in cases including where it is deemed necessary and reasonable for both investment trust funds, such transactions are exceptionally allowed, if they are transactions of listed securities, etc. based on fair prices. Regarding the scope of being “necessary and reasonable,” examples of such transactions are listed in the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc., but it is not necessarily limited to those examples. However in some carefully handled cases, transactions other than those listed as examples were not executed or the timings for placing sell or purchase orders were intentionally advanced or delayed to avoid resultant transactions between investment trust funds.

In light of this situation, it is appropriate to add to the list more examples of transactions that can be deemed “necessary and reasonable,” such as those, in cases where an investment limit is set for internal risk management, that can be used to avoid exceeding such limit.

In addition, regarding the securities that are listed on foreign financial markets that are currently not the subject of above-mentioned exceptional transactions, if they are listed on certain specific foreign financial markets, it is appropriate to allow transactions between investment trust funds.

- (v) Expanding the scope of exceptions to the rule of establishment and redemption in cash
Currently, it is provided that the investment trust shall, as a rule, be established and redeemed in cash; and only when there is no risk to the protection of beneficiaries, the establishment and redemption in-kind is exceptionally allowed. It is appropriate to add the following as exceptions.
 - (a) Allowing establishment and redemption in a combination of cash and in-kind
Currently, the establishment and redemption in a combination of cash and in-kind are not allowed. As a result, in the case of ETFs, which are established and redeemed in-kind, the establishment must be in-kind even for ex-right stocks; and those who held actual stocks may suffer financial loss in the value of rights. For this reason, there will be a period when the ETF cannot in reality be established and redeemed. It is therefore appropriate to allow a replacement of ex-right stocks, etc. with cash for the ETFs that are established and redeemed in-kind.
 - (b) Expanding the acceptable scope of establishment and redemption in-kind
Currently, the establishment and redemption in-kind are not allowed, except, for example, in cases where institutional investors establish and redeem ETFs under certain conditions. It is appropriate to allow the establishment and redemption in-kind in cases of investment trusts targeting institutional investors, who have extensive knowledge and understanding of investment when securities, etc. whose market value is readily determinable are used, as there is a low risk to the protection of beneficiaries.

(vi) Other measures

In addition, it is desired to take other appropriate measures concerning the following matters:

- Regarding the system for the investigation of the prices, exclude from the scope of application of the system the types of over-the-counter derivative transactions for which it is considered possible to ensure the fairness of the prices without investigating them, as the terms and conditions and the calculation method for economic value have been standardized to a certain extent based on the rules, which are stipulated, for example, by the Financial Instruments Exchange or the Financial Instruments Clearing Organization, and business practices.
- Regarding the timing and method of delivery of written documents to beneficiaries when activities that may involve risk of conflict of interest have been conducted, allow the notification to beneficiaries through such means as public announcement by electronic means, etc. made every time such activities are conducted or statements in the investment reports.

For the MRF¹, their net asset value is fixed at one yen per unit. When the net asset value falls below one yen per unit due to a sudden fall of the prices of bonds held or other factors, the appropriate operation concerning the additional issue, partial cancellation, etc. of the funds may be hampered. While paying attention to the developments in the global regulatory reform, it is appropriate to move forward with the consideration of measures that would contribute to the stable operation of MRF, including the exclusion, from the scope of application of “the prohibition of compensation of losses”, of the purchases of deteriorated investment assets by asset management companies, etc. for the purpose of ensuring smooth additional issue, partial cancellation, etc. of the funds by beneficiaries.

(3) Assurance of the supply of appropriate products that takes account of general investors

(i) Improvement, etc. of the investment report

As the investment reports contain important information for present and potential beneficiaries to make investment decisions, such information must enable beneficiaries to properly and easily understand the investment status.

In addition, in the cases of continuous public offerings of open-end type investment trust, it is appropriate that the securities registration statement, which is to be submitted once every year, and the annual securities report, which is required to be submitted as ongoing disclosure documents, be consolidated as much as possible, as the disclosure items in these reports are

¹ A bond investment trust established for the purpose of managing the funds for securities transaction settlement deposited with securities firms. The investment limit is imposed to ensure stable and safe investment in accordance with the rules of the Investment Trusts Association, for example, by restricting investments only to highly-rated bonds.

basically overlapped. To that end, the following revisions could be considered.

(a) Creating the investment report in two versions

Currently, it is provided that the information to be contained in the investment report shall be delivered to beneficiaries in one issue of the investment report. As a result, the reports are often large in volume and delivered, in principle, as printed documents, which makes it difficult for beneficiaries to select the information that they really want or need, and also causes asset management companies to bear large costs. In order to improve these problems, it is appropriate to create an “investment report to be delivered,” which contains extremely important information on the investment status and an “investment report (full version),” which contains more detailed information on the investment status and other information. In this case, the “investment report to be delivered” should be delivered to beneficiaries, in principle, in writing (printed form) or electronic form. On the other hand, regarding the full version investment report, it is appropriate to require the delivery in writing (printed form) only upon request by beneficiaries, while providing the full content by, in principle, easy-to-access electronic form for investors, such as a website. In addition, it is necessary to make sure to avoid a situation where, for example, the full version reports in writing (printed form) are delivered to all beneficiaries regardless of whether they make the request, which is contradictory to the intent of the revision.

(b) Revision of the items to be listed in an investment report

Assuming that the investment report is created in two versions, from the perspective of providing necessary information for beneficiaries to correctly understand the investment status, etc., the “investment report to be delivered” should contain the information on the present and past status of the investment trust in a manner that they can be compared with those of other investment trusts. The information should also be presented in an easy to understand manner by showing graphs and figures, and using easy and simple words and expressions. On the other hand, the “investment report (full version)” should continue to contain necessary and detailed information. In addition, in the review of specific items, in consideration of the fact that the “investment report to be delivered” is an important “communicating tool” that provides explanations on important matters regarding the investment status to existing customers, it is appropriate that business experts and others conduct further studies on the method of presentation of information, while seeking opinions and input from investors.

(c) Relationship with the annual securities report, etc.

While paying attention to the respective roles of the securities registration statement and the annual securities report and taking into account the recent development of information and communication technology, it is appropriate to revise both the securities registration statement and the annual securities report, from the perspectives of optimizing the cost of statutory

disclosure, and making the disclosure easier to understand for general investors.

The revision of the securities registration statement should preferably be conducted in the following direction from the perspective of eliminating overlapping of the items to be listed in the securities registration statement and the annual securities report:

- Introduce the incorporation method or the reference method for the securities registration statement; or
- Introduce a system in which, when documents containing equivalent information to the “Part 1 Securities Information” of the securities registration statement are submitted together with the annual securities report, these documents shall be deemed to be a securities registration statement.

In considering each proposal, the costs, benefits, and other aspects of introducing such a system should be compared and verified; and if it is reasonable and possible to legislate, it is appropriate to move forward with the latter proposal.

Regarding the revision of the annual securities report, it could be possible to eliminate the overlapping, with annual securities reports of other investment trusts, of the items to be listed concerning the information of settlor company, in an easy-to-understand manner for general investors, by flexibly using the substituting document system in which, when the substituting documents are submitted, they are deemed to form a part of the annual securities report. It is appropriate to consider approving the use, as documents substituting part of an annual securities report, of documents concerning the information of settlor company, which are prepared in accordance with the rules set forth by the Investment Trusts Association, a certified financial instruments firms association and published on a website.

- (ii) Introduction of a system for regular reporting to beneficiaries to enable understanding of total return

Currently, investors receive from their security firm, etc. a report on the outstanding balance of transactions, which contains information on the dividends, etc. from the investment trust for each period, etc. However, investors need to calculate themselves the amount of dividends for the entire investment period from the purchase of investment trust securities to date. From the perspective of developing an environment for making proper investment decisions, it is important to ensure that beneficiaries can easily understand the accumulated profit or loss and accumulated dividends for the entire investment period regarding the investment trust they hold.

Currently, many sales companies are already calculating the total return (accumulated profit or loss for a specified period) based on their own standard. However, there are sales companies that have not developed an IT system necessary for performing such calculation. Some sales

companies regularly report the results of calculation to their customers using their format, while other sales companies answer individual inquiries on an as asked basis

Given the situation mentioned above, it is required that the industry develop the framework in the direction described in the Attachment. At that time, it is appropriate to accept that individual sales companies provide in the report more information than specified in the framework.

(iii) Providing better explanation on fees on sales, trust fee, etc.

Currently, regarding the costs for the purchase and holding of investment trust securities, it is provided that the upper limit of the sales fee rate, the trust fee rate and the allocation rate between the asset management company, sales company and the fiduciary trust companies should be stated in the prospectus, etc. However, the explanations about the services, which can be enjoyed by investors as part of the fees and other charges they pay, are not necessarily sufficient for investors to understand. From the perspective of increasing the cost-consciousness of investors, and promote competition, it is appropriate to encourage the provision of better explanations.

(iv) Enhancement of the provision of information on risks, etc. at the time of sales, solicitation, etc.

Currently, it is provided in the laws and regulations that the purposes of the fund, characteristics, investment risks, etc. of the fund shall be stated in the distributed prospectus; and the content, presentation method, etc. are specified in detail in the rules of the Investment Trusts Association.

As products and their associated risks are becoming more complex (Refer to 2 (1) (ii)), In order to make proper investment decisions, it is considered important not only to understand the risk of principal losses for individual products, but also to understand the relative magnitude of risks. Given this situation, it is necessary to develop a framework for providing investors with information on product risks in an easy-to-understand manner.

In addition to continuing to provide qualitative explanation about the risks of individual investment trust products, it is appropriate to present information in an easy-to-understand manner so that quantitative comprehension and comparison become possible.

Regarding the specific content to be contained, from the perspective of providing investors with more easy-to-understand information on the risks of investment trust products, it is desirable to continue to discuss and sort out issues through practical discussions. At that time, it is required that the authorities and the industry standardize, to a certain extent, the items to be listed and the presentation method to enable objective comparison between funds, while leaving room for discretionary arrangements by individual asset management companies.

(v) Restrictions on the content of investment property (Regulations on certain types of risks)

Currently, the only restrictions on the content of investment property are: the restrictions specified in a Cabinet Office Ordinance on the risks associated with derivative transactions; and a certain level of restrictions imposed by the rule of the Investment Trusts Association concerning the subject of investment.

Regarding this, while fully respecting financial innovation and discretion on arranging products, it is desirable in general terms that proper selection of products be made by investors in the competition in the market, by ensuring that the risks involved in investment trusts are fully explained and disclosed.

However, investment products and their associated risks are becoming more complex (Refer to 2 (1) (ii)) as a result of the funds of funds becoming popular; and there are also structured bond-type invest trusts with significant credit risk.

As these complex risks and credit risks are difficult for investors to understand through prior explanations and disclosures, if such risks are not sufficiently reduced or dispersed, investors may suffer sudden or irregular losses. In order to address this problem, it should be considered to develop a mechanism to limit the amount of such risks in advance. Specifically, following mechanisms are to be considered:

- For the dispersion of credit risks, develop a framework for a certain level of quantitative regulations;
- For limiting the amount of risks associated with derivative transactions, standardize to a certain extent the method for calculating the amount of risks and provide a summary information; and
- To foreign-based investment trusts that are marketed in Japan or incorporated in Japanese investment trusts, the same regulation should be applied, taking into account the differences in legal system for each country.

Regarding this, some pointed out a concern that the discretion on arranging investment trust products could be restricted by imposing a quantitative regulation, level of which is fixed at one level, to control the risks of investment trusts. While paying attention to this concern, it is required to develop appropriate rules.

3. Investment Corporation Regulation

(1) Current state of Japanese investment corporations and the direction of actions

The investment corporation system, which established in 1998, has been mainly utilized in establishing J-REITs, as real estate was later added to the subject of investment. In about 10

years since then, the J-REIT has achieved a greater presence as a financial product.

On the other hand, the investment equity of J-REIT is a product whose underlying asset is real estate which generates stable cash flows; however, it is in fact largely subject to fluctuations in financial and capital markets. At the time of the Lehman crisis, financial issues such as the restrictions on sources of financing emerged. Impacted by the turmoil of financial and capital markets, financial institutions changed their lending stances, which in turn had a serious impact on investment corporations' financing. In addition, although it was initially intended to be a middle risk and middle return product, the market conditions made the price volatility of investment equity higher, which weakened investors' willingness to invest. Considering these situations, it is considered necessary to take measures to diversify sources of financing and capital policy instruments, while taking into account the fact that some pointed out, in Japan, there are many restrictions on such financing sources and instruments compared with those on REIT in other countries.

Taking a look at the operations of investment trusts, it is also observed that the parent company, etc. of an asset management company (hereinafter referred to as the "Sponsor Company") plays a great role in areas such as providing personnel, know-how and investment properties. On the other hand, although the dependence on the Sponsor Company has a benefit, for example, of adding credibility, it was pointed out that there is a concern that the interests of the Sponsor Company and those of investors are not necessarily the same. In order to further increase the confidence of investors in the investment corporation system, it is necessary to take action to ensure transparency of investment corporations' operations and transactions, including appropriate discipline for such conflict of interest.

(2) Improvement of the stability of financial foundation, including the diversification of fund-raising means

(i) Diversification of sources of financing and capital policy instruments

Proposed specific measures for the diversification of sources of financing and capital policy instruments include introductions of rights offering, convertible investment corporation bond, class investment equities, capital reduction without compensation and acquisition of own investment equity. Among those, the convertible investment corporation bond and the class investment equities are considered to possibly require a higher level adjustment of interests between investors compared with other instruments.

On the other hand, the investment corporation is a system in which investors' funds are mainly invested in certain assets in a focused manner, and investment income is distributed to investors. As a general rule, operations are required to be outsourced, and its governance structure is simple. In addition, a system of deemed assent was introduced based on an understanding that,

in general, investors are primarily interested in returns, and give basic and general approval to the investment corporation's overall operations as far as they are being carried out smoothly.

If the current simple governance structure based on the deemed assent system remains unchanged, the problem is still there, that is, the above-mentioned adjustment of interests is difficult to perform. For this reason, regarding the convertible investment corporation bond and the class investment equities, it is too early to introduce them in the revision of the legal framework for investment corporations.

On the other hand, regarding the rights offering, the capital reduction without compensation and the acquisition of own investment equity, the need for such adjustment of interests is low, as they would not hinder the fair treatment of investors and contribute to the stable operation of investment corporations. It is therefore appropriate to move forward with the improvement of the system for the introduction of those instruments, while considering the nature of investment corporations.

(ii) Revision of the requirements for short-form merger

Currently, it is provided that, for a merger of investment corporations, a resolution of the investors' meeting of the investment corporation surviving the merger is not required, if the number of units of investment equity after allotting investment equities to investors of the investment corporation extinguished upon merger is less the number of total number of units of authorized investment equity of the investment corporations surviving the merger (short-form merger). Regarding this, some pointed out a concern that interests of investors could be harmed as a short-form merger may be approved even when such merger could have a significant negative impact on the financial condition of the investment corporation surviving the merger. It is therefore appropriate to revise the requirements, for example, to approve short-form merger only in cases where the ratio of the number of units of investment equity of investment corporations surviving the merger allotted to investors of the investment corporation extinguished upon merger to the total number of units of issued investment equity before the merger is less than or equal to a certain percentage.

(3) Assurance of management that can be better trusted by investors and of the transparency of transactions

(i) Introduction of a mechanism for enabling decision making that would increase the confidence of investors

Currently, it is provided that, asset management operations of an investment corporation are required to be outsourced to an external asset management company. An entity to which asset management is outsourced, in principle, has discretion in conducting transactions with assets under management; and when carrying out any transaction with interested parties of the

outsourced entity, such transactions must be reported to the investment corporation, etc. However, since those reports are made after transactions, some pointed out that such reporting cannot necessarily stop the transactions that would harm the interests of investors.

Under these conditions, initiatives to improve governance should possibly be taken, for example, to put transactions with interested parties under surveillance of either the board of officers or investors' meeting of the investment corporation, or the compliance committee on the asset management company, members of which include external experts. Since a majority of the members of the board of officers of the investment corporation are third party persons (supervisory officers) who are independent of the asset management company, as a first step, it is expected, by strengthening the power of the investment corporation's board of officers to improve surveillance of transactions with interested parties. To be specific, it is appropriate to require obtaining prior approval from the investment corporation's board of officers before carrying out certain significant transactions between the investment corporation and interested parties of the asset management company. In this case, regarding the supervisory officers, it is appropriate to require that they are not interested parties of the current asset management company, and, in addition, that they are not interested parties of the Sponsor Company.

Currently, it is also provided in the practical guidelines of the Financial Instruments Exchange, etc. that a listed investment corporation is required to publish a summary of appraisal reports of acquired properties. In order to improve the ex-post facto checking function of market participants, for the transactions with interested parties of the asset management company, in addition to requiring more items to be disclosed concerning the summary of appraisal reports, more detailed information on the basis of calculation of appraised value should be published, while cautiously handling the cases where publishing specific information would rather harm the interests of investors for competition-related or other reasons.

(ii) Introduction of regulations on insider trading

Currently, it is provided that the trading of investment securities of listed investment corporations are, in principle, not subject to regulations on insider trading. The reason behind this is considered that there is relatively little risk of insider trading, since investment equity prices are formed based on the net asset value of assets under management. However, looking at the actual movements of the prices, prices significantly fluctuate when, for example, Sponsor Company is changed. If a person who has access to such information obtains it before it is made public and then carries out transactions based on the information, it would damage the confidence of investors in the fairness and soundness of the securities market.

In foreign countries, generally speaking, those securities that are equivalent to investment securities of listed investment corporations in Japan are subject to regulations on insider trading.

In addition, many of the listed investment corporations in Japan explain to investors that the fact that their investment securities are not subject to insider trading regulations is a risk

Given these conditions, it is appropriate to make the trading of investment securities of listed investment corporations subject to insider trading regulations, while paying attention to the situations investment corporations are in

Specifically, when defining the scope of entities subject to regulations, it is appropriate to treat asset management companies in the same manner as the investment corporations themselves, instead of positioning them as “entity who has concluded a contract with investment corporation” since, under the investment corporation system, important information on acquired assets is obtained, kept, and managed mainly by asset management companies, entities to which asset management operations are outsourced. Sponsor Companies should also be made subject to regulations, for reasons that the above-mentioned price fluctuations are observed and that they play a significant role in providing personnel, know-how and investment properties and in other areas. It is appropriate to, in addition to investment corporations and asset management companies, make those persons subject to regulations who are related persons of Sponsor Company and learn of a material fact regarding their business, etc. and who are recipients of such information from the said related persons.

Regarding the “material fact,” it is appropriate to move forward with the development of a specific system, in consideration of the fact that the following kinds of information would affect investors in their investment decision-making:

- Changes to content and terms and conditions of investment equity (e.g. announcement of public offering of new units);
- Changes in assets of investment corporation (e.g. announcement on a move-out of a large tenant, announcement of revision to performance forecast);
- Changes in performance and business of investment corporation (e.g. announcement of a petition for commencement of bankruptcy proceedings); and
- Changes in performance and business of asset management company and change of Sponsor Company, etc. (e.g. announcement of a change of Sponsor Company)

(4) Other measures

- (i) Revision of restrictions on the holding of the majority of voting rights for the purpose of promoting the acquisition of overseas real estates

Currently, an investment corporation’s overseas real estate acquisition itself is not prohibited.

On the other hand, for the purpose of limiting control over other business entities, the

Investment Trust Act prohibits the holding of the majority of voting rights attached to shares in other business corporation. Because of this, there are some cases where, in a particular country

that has regulations on the investment in real estate by foreign capital, the acquisition of real estate is in reality difficult. In this situation, it is appropriate to, in cases where it could be deemed to be practically equivalent to investment corporation's acquisition of overseas real estate, allow the holding of the majority of voting rights attached to shares in a special purpose company (SPC) or vehicle (SPV) for the acquisition of the overseas real estate, while ensuring the credibility of the investment corporation system, and in consideration of the nature of investment corporations and the intent of limiting control over other business entities.

In addition, there was an opinion that, based on the idea that investment corporations' method of real estate investment should be made more flexible and investment efficiency should be improved, the same rule should be applied to domestic real estate, and multi-layered SPV structures should be approved. However, it is also important to consider investment corporation's simple governance structure and the nature of being a conduit, and to avoid the situation where investment corporations' subject of investment becomes excessively complex. Thus, continued discussions are necessary

(ii) Introduction of a system for making a request for injunction against issuance of units of investment equity

Currently, a system is not in place for investors to directly request with the investment corporation for an injunction against issuance of units of investment equity. However, it is appropriate, from the perspective of protecting investors, to develop a system for making a request for injunction in conjunction with the above-mentioned diversification of sources of financing and capital policy instruments.

In addition to the above, appropriate measures should be taken concerning the following matters:

- Regarding the term of office of officers of investment corporation (the term of office of a corporate officer may not exceed two years, and supervisory officers, four years), in consideration of the current situation in which investors' meetings are held ahead of the original schedule and post-dated appointments of officers are made, in cases where the schedule of investors' meeting is specified in advance in the certificate of incorporation of investment corporation (for example, a meeting is to be held within a specified period from the end of the two-years financial period), the term of office of officers should be until the conclusion of investors' meeting;
- Regarding the requirement that a notice of convocation of an investors' meeting shall be published no later than two months prior to the date of the meeting, as in the above-mentioned case where the schedule of investors' meeting is specified in advance in the certificate of incorporation of investment corporation, it should be provided that a public notice of investors' meeting of such investment corporation may be omitted, applying *mutatis mutandis* the provisions on shareholders meeting of a stock company in the Companies Act; and

- Regarding the fact that certain changes to the content of administration entrustment agreement shall be notified to each investor, it should be provided that, for minor changes with no impact on the content of entrusted administration, the said notice may be substituted for statements, in the investment management report, of such changes during the relevant accounting period.

4. Conclusion

Based on the outcome of the above-mentioned discussions and deliberations, and on the ideas presented in this Report, it is expected that appropriate developments, improvements, etc. of systems will be made, and the authorities, etc. will follow up on the initiatives taken by the relevant industries in conjunction with such system developments.

End of document

2. Investment Trust Regulation

(3) Assurance of the supply of appropriate products that takes account of general investors

(ii) Introduction of a system for regular reporting to beneficiaries to enable understanding of total return

Regarding specific matters to be reported such as the method of calculation, the scope of targets, and the method of reporting, the following directions could be taken:

○ Basic calculation formula is as follows:

(Market value at the time of the calculation + Accumulated amount of dividends + accumulated redemption amount) — Accumulated purchase amount

○ All publically offered investment trusts (including publically offered foreign investment trusts) should be included. However, certain instruments (daily settlement type investment trusts such as MRF; ETF) are allowed to be exempted.

○ Recipients are private investors.

○ Regarding the past period to be covered for the calculation of total return, feasibility should be verified as to the possible coverage.

○ Specific method of reporting should be either delivery in writing /printed form (mail delivery), through e-mail, or listing on a page of website that is dedicated exclusively to customers (in this case, the adopted method must be unfailingly notified in advance to customers). In cases where sales volume is low, and it is difficult for relevant sales companies to develop an IT system, etc. needed, on a condition that advance notification will be unfailingly made to customers, from the perspective of help start efforts to report total return as soon as possible, a system of responding to individual inquiries made by customers may be exceptionally allowed.

Considering the necessary preparation period for sales companies to adjust their IT systems, etc., a reasonable period of preparation should be allowed between the time of announcement of the content of the system and the implementation. In addition, while all investment trusts marketed after the system implementation are subject to the reporting, it is considered that the investment trusts that have been already marketed at the point of implementation should also be subject to the reporting.