Investment Trust Law Revisions To Expand Scope Of Investments

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On 23 May 2000 the Diet approved the draft bill to revise the "Law on Securities Investment Trusts and Securities Investment Corporations," which would allow the establishment of collective investment schemes able to invest in a much wider range of asset types. In this report we will outline the main points of the new bill, and examine its likely impact and future issues.

1. Reform Of Japan's Investment Trust System

There have been 2 major reforms to Japan's investment trust system in the 1990s which are briefly outlined in Table 1.

Table 1 1990s Reforms To Japan's Investment Trust System

Area	1995 (Reform)	1998 (Revised Legislation)
1. Development of securities investment trust management business	● Changes to licensing system (allowing investment trust management firms to also function as investment advisory firms)	● Changed from licensing system to registration system ● Firms allowed to conduct securities business as well as investment trust management and advisory business
2. Relaxation of regulations governing permitted investments	● Investments in derivatives for non-hedging purposes allowed ● Restrictions on overseas investments abolished	
3. Disclosure	● Expansion and clarification of contents required in prospectus (at issue) and investment reports (required to be sent twice a year)	● Securities & Exchange Law based disclosure system applied to trust beneficiary certificates (requirements to submit a securities issue registration statement on issue and have statutory audit)
4. Product development liberalization		● Lifting of ban on private placements ● Establishment of a corporate-type investment trust (investment corporation) system
5. Establishment of Fair Trading Rules	● Ministerial ordinances and Investment Trust Association regulations (clarification of what constitutes a breach of fair trading rules, administrative penalties for breach of rules etc.)	
6. Performance evaluation system	● Improvements to Investment Trust Association's system of publication of investment performance ● Provision of raw data to a evaluation/rating agencies	

Source: NRI

1) Reforms Enacted In 1995

The regulatory reforms of investment trust business enacted in 1995, consisting of the Ministry of Finance's "Outline of Investment Trust Reforms" and the Investment Trust Association's "Enactment of Investment Trust Reforms," announced in December 1994, had the aim of relaxing the barriers to entry into investment trust management business and liberalization of the scope of allowed investment activities.

The consequence of allowing companies to operate both investment trusts and investment advisory services was to open the doors to a number of foreign entrants to the market. The number of investment trust management firms operating in Japan then grew from 28 at the end of 1994 to 39 by end 1996. Following which a large number of investment trust companies were established by insurance companies and by foreign firms setting up joint-ventures with local firms, resulting in over 72 investment trust companies operating by end February 2000.

Table 2 Growth In The Number Of Investment Trust Companies

	Dec. 1993	Dec. 1996	Sept. 1998	Feb. 2000
Securities companies	15	16	12	8
Banks	5	8	10	12
Insurance companies	0	1	4	12
Foreign entrants	6	14	24	33
Other	0	0	0	7
TOTAL	26	39	50	72

Notes: (1) Up to Sept. 1998 the categories used are based on those of Megumi Suto "Structural Issues Concerning Japanese Investment Trusts" (in S. Rohyama "Investment Trusts and Asset Management" (Nihon Keizai Shimbun publications)).
(2) Categories for Feb. 2000 are NRI's ("Other" includes joint-ventures and non-affiliated investment trust companies)
Source: NRI, from materials supplied by the Investment Trusts Association

The relaxation of investment rules allowed investment trusts to invest in derivatives for purposes other than hedging, which resulted in the appearance of "bull-bear funds"[1] and other new fund types.

In terms of sales channels, direct selling by investment trust companies had been allowed since 1993, before the 1995 reforms. With banks and insurance companies able to sell investment trusts at retail branches to customers from December 1998 a true diversity of sales channels was finally being established.

The intensification of supply-side competition and proliferation of sales channels that these systemic reforms have brought about in the investment trusts market should contribute, albeit gradually, to a stock market recovery and increased capital inflows.

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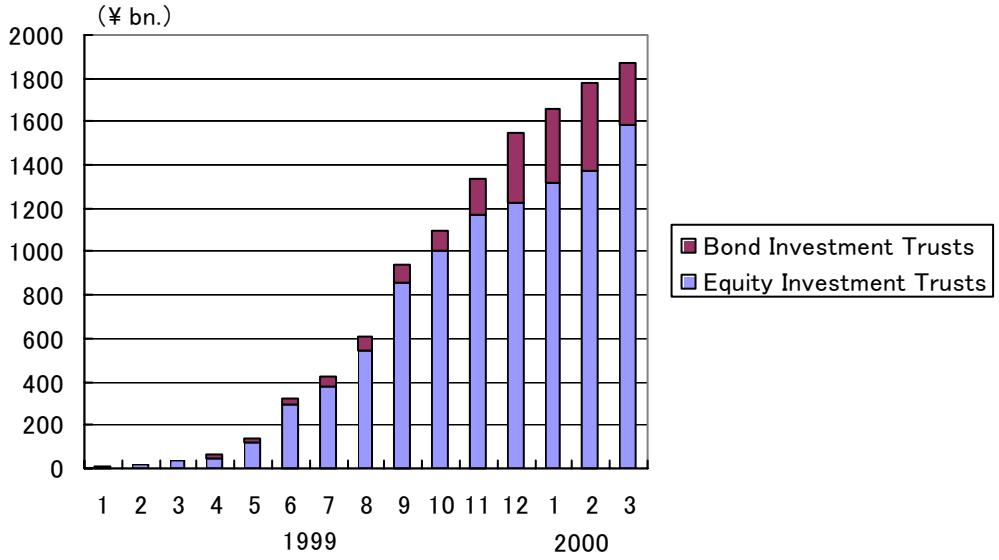
1 Bull-bear funds are basically regular open-ended equity investment trusts which invest in derivatives such as stock index futures, bond futures and exchange contracts in an effort to outperform the index.

2) Revisions To The Investment Trust Law (1998)

Changes to the Securities Investment Trusts Law (subsequently to be known as the "Law on Securities Investment Trusts and Securities Investment Corporations") was a central piece of the Financial System Reform bill[2] enacted in December 1998 that ushered in the reforms collectively known as Japan's "Big Bang." The main revisions were: (1) changes to the regulations governing entry into the market as an investment trust management firm; (2) introduction of a private-placement system; (3) introduction of a corporate-type investment trust (investment corporation) system.

As we saw in the previous section, the revised market entry regulations resulted in a steady increase in market operators. Further, the private placement system that allowed for the selling of investment trusts tailor-made to the investment needs of a small (up to 50) number of investors has been popular with company pensions, drawing in some ¥1.5 trillion in the one year since its inception.

Figure 1 Assets in privately placed investment trusts (as at each month end)



Source: Investment Trusts Association

The establishment of a corporate-type investment trust system in Japan had been long in coming, despite persistent calls from various quarters that Japan should follow the example of other countries in setting up such a system. Such a structure was thought to be much more conducive to the interests of corporate governance, since the company consisted of both a board of directors and held investors' general meetings in a manner similar to that of a joint-stock company. However, throughout the whole of 1999 there was not a single case of such an investment corporation being set up.[3]

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2 For a detailed overview of the Financial System Reform Act, please refer to S. Osaki "Outline Of The Financial System Reform Act" (Capital Research Journal, Summer 1998).

3 Nippon Real Estate Investment Trust Co., Ltd. registered its "J-Real Estate Investment Corporation" on 4 April 2000, which was accepted by the authorities. Investing in SPC issued bonds, this will be Japan's first investment corporation.

3) Focus of the current investment trust system reforms

The current draft revisions to Japan's investment trust system are a further development from the previous two instances, aimed at ushering in a financial system infrastructure that is fit for the 21st century. In fact, Japan's previous legislation governing financial services was built around a structure of "vertical" separation along financial product lines, with separate legislation governing each financial product type. By contrast, the current revisions to investment trust law represent a move towards a function-based structure where rules for collective investment schemes, where investors' funds are brought together and handed over to market professionals to manage and invest, are comprehensive enough to cover a wide range of asset types.

The Financial System Council, an advisory panel to the Ministry of Finance, set up a "Collective Investment Schemes Working Group" whose 10-month examination resulted in a second interim report published on 21 December 1999. This demonstrated a major change in direction with regard to investment trust law, and this report strongly influenced the recent revisions.

The major legal revisions included in this bill were: (1) expansion of the scope of permitted investments; (2) legislation regarding investment trust management companies (such as increasing fiduciary responsibility and prohibiting actions were conflicts of interest may arise); (3) establishment of a discretionary-type investment trust system where the trustee, a trust bank, can invest in specified assets of its own accord (without relying on investment instructions from an investment trust management company). Expanding the scope of permitted investments was the most revolutionary reform in terms of Japan's investment trust system, since previously investment trusts had to invest primarily in marketable securities. Essentially this changed the definition of Japan's investment trust scheme, and accordingly the name of the governing law was changed from the "Law on Securities Investment Trusts and Securities Investment Corporations" (the current investment trust law) to the "Law on Investment Trusts and Investment Corporations" (the new law) (i.e. the word "securities" had been dropped from the title). Below we will examine the major items of revision in turn.

2. Expansion of scope of permitted investments

The new investment trust law had as its stated purpose "the establishment of a system whereby an investment trust or investment corporation may be set up to invest the funds collected from investors with returns on the investments distributed among the investors and to ensure the appropriate management of such investment schemes, and additionally to protect the interests of the purchasers of the various securities issued by such entities, to make the process of investment in marketable securities and other assets more straightforward, and thereby to contribute to the sound development of the overall economy" (Article 1 of the new law). Compared to the definition of investment trusts in the current investment trust law, that they were "a vehicle to make collective investments in principally marketable securities," the new legislation explicitly aims at a much more comprehensive type of collective investment scheme.

The new investment trust law changes the previous definition of "principally marketable securities" as the scope of investment to "principally marketable securities, real estate and other assets as and for which government ordinance may be required for the furtherance of investment opportunity" (Article 2-1).

Apart from marketable securities and real estate, the scope of permitted investment targets is therefore to be stipulated at a detailed level by government ordinance. The Financial System Council discussions however clearly concluded that the purpose of the new legislation was to facilitate the establishment of collective investment schemes with a wide scope of permitted asset investment targets and freedom to design and invest in innovative financial products. Therefore the effect of the new legislation will probably stretch far beyond the establishment of real estate investment trusts that have been the focus of most recent attention. This should stimulate the development of new financial products that were outside the scope of the previous definition of investment trusts. On the other hand however, the expanded scope of permitted investments would result in investment trusts purchasing assets which may be relatively illiquid and whose market price is difficult to determine. In which case, new problems arise, such as what constitutes sufficient disclosure regarding these investments. Such issues will have to be tackled by future government legislation. Regarding the marketing of trust beneficiary certificates, we understand that this will continue to be governed by the Securities & Exchange Law insofar as they fall under the definition of marketable securities.

3. Investment trust management business

Under the new investment trust law the previous definition of an investment trust management company will change. Firstly, the title of "asset management companies" that invest in assets on behalf of securities investment corporations (corporate-type investment trusts) (Chapter 3-2, paragraph 3 of the current investment trust law), will be changed to "investment corporation asset management companies." As a result of which, companies that operate "investment trust management business" (trust management companies issuing investment instructions for non-discretionary investment trusts[4]) or "investment corporation asset management business" (companies that manage the investments on behalf of registered investment corporations) are defined as investment trust management companies (Article 2, 16-18 of the new investment trust law).

1) Approval criteria

In order to operate as an investment trust management company, approval from the Financial Reconstruction Commission is required (Article 6 of the new law).

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4 Non-discretionary investment trusts operate in the same way as the previous contract-type investment trusts. The legal definition is: "Investment trusts established under this law whose purpose is to invest in marketable securities, real estate and other assets as so prescribed by government ordinance on the instructions of the administrator of the trust assets and who apportion the beneficiary rights between the holders of those rights" (Article 2-1).

The application must be accompanied by draft investment and investment management contracts and other documents as stipulated by prime-ministerial ordinance in addition to the articles of incorporation. Further, the application must include details of planned business operation methods, to include the type of investment instructions and investment assets that will be held (e.g. for investment trusts whose purpose is mainly investment in real estate the application is to include the type of investment instructions to be issued, or whether it will be managing the assets of investment corporations) (Article 8).

Article 9 of the new investment trust law prescribes those conditions which would bar a company from receiving approval to operate as an investment management company, which are: (1) joint-stock companies with capital less than the amount prescribed by government ordinance; (2) entities who have previously acted in contravention of related laws (Table 3). As the scope of permitted investments is widened, there are now a significantly larger number of laws the previous contravention of which would prevent a company from being approved. If companies are to be involved in real estate investment they must be licensed or approved under the Real Estate Broker Law.

Table 3 Laws contravention of which disqualifies the applicant from being an approved investment trust management company

- Any company contravening the laws listed below and is consequently subject to a financial penalty is ineligible for up to 5 years following the enforcement of the penalty or from the date when the penalty expired
- Any company whose approval, licence or registration under the laws below is revoked is ineligible for 5 years from the date of revocation
- Any company where a director, auditor or employee specified by government ordinance has been judged ineligible according to the laws below shall be ineligible

A) Investment Trust Law*
B) Investment Trust Business Law
C) Law Concerning the Concurrent Operation of Trust Bank Business by Financial Institutions
D) Securities and Exchange Law*
E) Commodities Trading Law
F) Real Estate Broker Law
G) Law Concerning Supervision of Receiving Capital Investment, Deposit Holding and Interest Rates
H) Installment Sales Law
I) Law on Foreign Securities Firms*
J) Law Regarding Broking of Futures on Overseas Commodities Markets
K) Law on the Regulation of Loan Business
L) Law on Trade Contracts for Deposits of Specified Commodities
M) Law on the Regulation of Securities Investment Advisory Firms*
N) Law on the Regulation of Mortgage Companies
O) Financial Futures Trading Law
P) Law on the Regulation of Commodities Investment
Q) Law on the Regulation of Specified Bonds
R) Real Estate Syndication Act
S) Asset Securitization Law
T) Law Concerning Financial Institutions Issuing Bonds for Financing Lending Operations

Note: Contravention of laws marked * disqualifies a company from being eligible under current legislation
Source: NRI, from the Law on Investment Trusts and Investment Corporations

2) Scope of business

Article 18 of the current investment trust law stipulates that an investment management company, outside of management of investment trusts, is allowed to conduct "asset management business (investment corporation asset management)" and "investment advisory business or activities related to discretionary contracts."

The new legislation removes the above clause, and in its place states that investment trust management companies may, in addition to investment trust management business and investment corporation asset management business, engage in: (1) investment advisory business or activities related to discretionary contracts; (2) real-estate management; (3) real-estate syndication[5] operations; (4) other business activities as per government ordinance, with registration by the Financial Reconstruction Commission (Articles 34-10-1,2).

The inclusion of "real-estate management" services confirms that investment management companies operating real-estate investment trusts are to be allowed to manage property and create / renew rental and leasing contracts. "Real-estate syndication business" presumably refers to allowing the recruitment of syndicated funds for investment in real-estate either alongside or prior to the formation and operation of a real-estate investment trust. Further, investment management companies may, subject to approval by the Financial Reconstruction Commission, engage in securities or real estate brokerage business (Article 34-3). Other forms of business are as a rule prohibited (Article 34-11).

3) Investment management company rules of conduct

(1) Duties towards beneficiaries

In addition to the current law's requirement for the investment management company to act in good faith on behalf of the beneficiaries (must act in good faith in the issuance of investment instructions for the management of investment trust assets and other business operations on behalf of the beneficiaries), the new legislation adds a further duty to act as a right and proper asset manager (to act with the care and diligence of a prudent person in the issuance of investment instructions for the management of investment trust assets and other business operations for the beneficiaries) (Article 14 for non-discretionary type investment management companies, Article 49-8 for discretionary type investment management companies, and Article 34-2 for management of investment corporations).

(2) Prohibition of trades that are against the profit interests of beneficiaries

The new legislation follows the code of conduct of the old legislation practically entirely as regards conflicts of interest. Those trades that are prohibited due to conflicts of interest are listed in Table 4.

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5 Real-estate syndication is a form of private property investment. Under the Real Estate Syndication Act, investors can jointly invest in real estate either through a Tokumei Kumiai, a Nin-i Kumiai or a trust. Tokumei-Kumiai, the most frequently used formation, is similar to a limited partnership according to Japan's Commercial Code, while a Nin-i Kumiai is similar to a general partnership according to the Civil Code.

Table 4 Trades prohibited due to conflict of interest

(1) Trades between the investment trust management company itself or its directors and the investment trust (unless specified by government ordinance this applies to non-discretionary type investment trust management companies) (Article 15-1-1)
(2) (Where an investment trust management company operates more than one fund) Trades between investment trusts or investment corporations, or between an investment trust and an investment corporation (Article 15-1-2,3), Article 34 3-1-5)
(3) Trades based on fluctuations in prices on underlying specified marketable securities for the purpose of profiting a third-party that is neither the investment trust management company itself or the beneficiaries (Article 15-1-4, Article 34-3-1-6)
(4) Irregular trades that are not profitable for either the beneficiaries or the investment trust management company (Article 15-1-5, Article 34-3-1-7)
(5) Trades undertaken for the purpose of profiting interested parties that are not profitable for either the beneficiaries or the investment trust management company (Article 15-2-2, Article 34-3-2-2)
(6) Trades undertaken for the purpose of profiting clients of interested parties that are not profitable for either the beneficiaries or the investment trust management company (Article 15-2-1, Article 34-3-2-1)
(7) Trades recognized as superfluous with regard to investment policy and undertaken for the purpose of profiting interested parties (Article 15-2-3, Article 34-3-2-3)
(8) Trades undertaken for the purpose of creating a false market in securities being underwritten by a securities company that is an interested party (Article 15-2-4, Article 34-3-2-4)
(9) Other actions as specified by prime ministerial ordinance

Source: NRI, from the Law on Investment Trusts and Investment Corporations

Rules 5 to 8 in Table 4 are there to prevent persons or companies that have influence over the actions of the investment trust management company (e.g. parent companies) from giving instructions to the investment trust management company to carry out trades for the purposes of profiting themselves or their clients. "Interested parties" are defined by government ordinance as persons possessing over half the shares in or having a particularly close relationship with the investment trust management company. Rule 6 prevents interested parties engaged in certain areas of business[6] to instruct an investment trust management company to carry out trades that are not profitable to the beneficiaries, for the sake of interested parties' clients.

If an investment trust management company carries out a trade that involves a conflict of interest, then according to prime-ministerial ordinance, the investment trust management company must grant the same trade terms to each beneficiary of the investment trust assets (Article 28 of the new law). However, the same article stipulates that with regard to the beneficiary rights to the investment trust assets concerned, if the subscription to the trust was public, then the same trade terms have to be granted to "knowing beneficiaries."

The code of conduct for investment trust companies operating discretionary investment trusts is defined in Article 49-9 of the new law.

6 The types of business to which this rule applies are as follows: Investment trust management companies, trust companies, financial institutions that operate trust business, investment advisory firms, real estate brokers, real estate specified joint businesses, other firms whose business involves certain specified assets as specified by government ordinance.

(3) Asset assessment

An investment trust management company must have the price and other particulars of assets assessed at the time of any investment action (purchase or transfer of specified assets or any other action as stipulated by prime-ministerial ordinance), by a person other than an interested party or trustee (Articles 16-2, 34-4 and 49-11 of the new law). Real estate investment trusts must have the value of their assets assessed by a certified real estate appraiser (Article 16-2-2).

4) Objections to changes to the investment trust contract

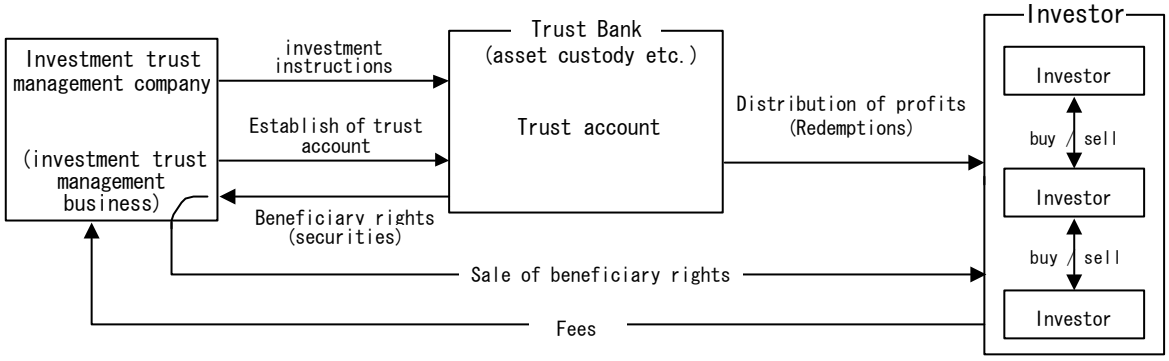
Where the current law only requires a notification and grant to change the trust contract, the new law recognizes investors' rights to file objections and request to be bought out. If the investment management company wishes to make any major changes to the trust contract of the investment trust, they must inform the beneficiaries to this effect leaving a period of one month in which an objection may be filed. If during this period the number of beneficiaries filing an objection represent over half of the total units of the trust, then no changes to the trust contract can be made (Article 30-1~4). Further, if changes are made to the trust contract, then the objecting beneficiaries have the right to request to have their own beneficiary certificates bought out by the trustee (trust bank) at a fair market price assuming no changes had been made (Article 30-2).

4. Establishment Of A "Discretionary-Type Investment Trust System"

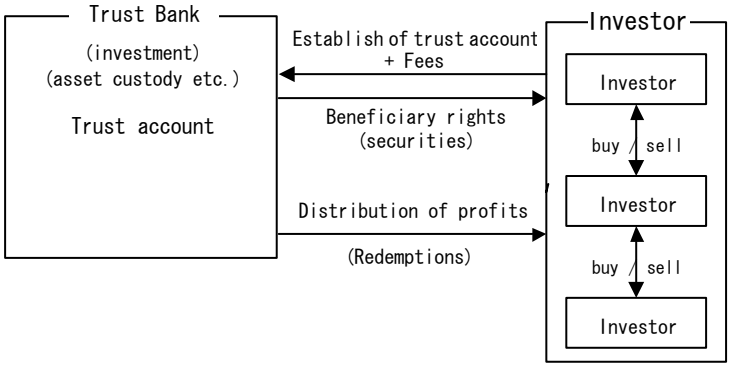
The new law will rename the previous "securities investment trust" schemes as "non-discretionary investment trusts", which will then be one of the two types of contract-type investment trust, and create the new "non-discretionary type investment trust." As a result, there will be a total of 3 investment trust models, as shown in Figure 2.

Figure 2 Types of investment trusts in Japan

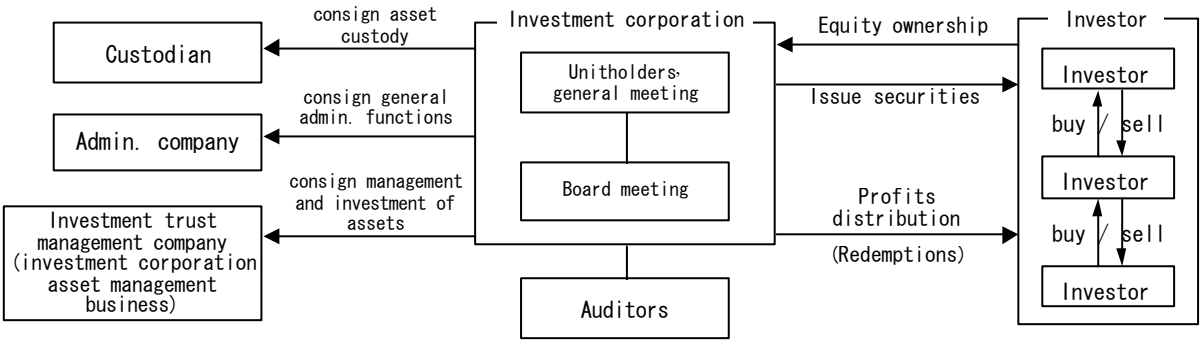
Non-discretionary investment trusts (contract-type investment trusts)



Discretionary investment trusts (contract-type investment trusts)



Investment corporations (corporate-type investment trusts)



Source: NRI, based on Ministry of Finance

The legal definition of a discretionary investment trust is "an investment trust that pools funds from a number of investors based on a single trust contact, with the trustee investing these funds predominantly in a pre-determined class of asset at its own discretion" (Article 2-2).

The discretionary-type investment trust system allows investment trust companies or financial institutions who have investment trust operations to set up a new type of trust which, under a trust account, can invest in a number of set assets according to its own investment judgement. Compared to the existing contract-type non-discretionary trusts this type does away with the need for an investment trust management company, allowing trust banks to set up and operate a trust on their own.

However, the new legislation will still not allow discretionary investment trusts to be set up that invest predominantly in market securities (Article 49-3). These new types of trusts have therefore been introduced to accommodate the increased scope of asset types allowed, and have particularly the establishment of real estate investment trusts in mind.

5. Investment Corporations

1) Investment corporation bonds

The new legislation will change the name of "securities investment corporations" to simply "investment corporations," while the most significant changes centre on loan procurement and investment corporation bonds.

While the current legislation did not even mention whether it was possible for securities investment corporations to borrow funds, the new law brings in a new item, "maximum amount which may be borrowed in the form of loans or through bond issuance," to be required in the corporate bylaws when the investment corporation is established (Article 67-1-16). While further government ordinances will presumably lay down more details such as conditions under which funds can be borrowed and the permitted ratio of debt to net worth of the trust, this has at last opened up to investment trusts the option of raising their own financing.

Closed-end type investment corporations (investment corporations where the memorandum stipulates that repayment of funds invested cannot be made on request of the investor) will be able to issue investment corporation bonds, which will be similar to the corporate debt of joint-stock companies, to a maximum amount as set out in the corporate bylaws (Article 139-2). When marketing these bonds the investment corporation must choose a bond management company to which it will entrust the repayment, custody and administration of the bonds. The investment corporation bonds thus issued will be regarded as bonds issued under the Commercial Code (Section 2, Chapter 4 Section 5), so investment corporation bond management companies will be regulated by the Commercial Codes rules concerning bond management companies, and the bonds will be subject to registration under the Bond Registration Law (Articles 139-5-7 and 139-6 of the new law).

2) Duties of related bodies

The new law introduces the duty of acting with the care and diligence of a prudent person towards the investment corporation by its creator, administration company and custodian (Articles 70, 112 and 209 of the new law). Further, the custodian must keep the investment corporation's assets separate (in order to keep custody in a proper manner, in accordance with prime-ministerial ordinance the custodian must keep the investment corporations' assets separate from its own) (Article 209-2).

6. Conclusion – A Revolution In Investment Trust Asset Holdings?

The draft bill revisions were passed on 23 May 2000 and will go into force from April 2001. It is believed that companies are likely to be affected by the new legislation have most likely started preparing for the new system already.

Regarding the overall impact of the reforms, it is to be hoped that the expanded scope of permitted investment targets will result in a real revolution in the types of financial products that investment trusts hold in their portfolios. In the US and Europe a large variety of different investment funds are now being marketed, including commodity funds, gold / silver / natural resource funds, private equity funds, mortgage funds, bank loan funds and emerging country funds. There are also "funds of funds," a combination of various fund types, being sold. The way has been opened in Japan for many different types of companies to enter the investment trust market – not just foreign financial institutions and real estate companies, but also commodities futures traders, trading companies and non-banks. This will likely result in a greater variety of financial products being developed.

While various investment trust schemes may be made possible by the current reforms, whether the market as a whole is to succeed will largely depend on the market environment and the efforts of its participants. The reason why securities investment corporations did not really take off before, despite much expectation, was partly due to the systemic shortcomings recognized in the beginning, namely that boards had to be composed of independent directors (legally liable to the shareholders) that most people are hesitant to become, and of the costs of holding annual shareholders' meetings. It was also true during these years that contract-type investment funds (mainly of the open-ended type) have attracted investment and made relatively good returns, so that there was little incentive for investment management firms to set up company type investment trusts. While some are of the opinion that corporate-type investment funds, where investors and third-parties can monitor the fund's activities more closely, are more suited to investments in illiquid asset types such as real estate, it is difficult to say at the moment whether they will be able to overcome the difficulties that are now associated with investment corporations. The effects of these reforms and the future development of investment trusts in Japan will continue to be watched closely.