Newsletter No. 003 | February 20th 2024

Report of the Working Group on Capital Market Regulations and Asset Management Task Force of the Financial System Council

-“Product Governance” and “Rectifying Japan‘s unique business practices in investment trusts”-

Atsumi & Sakai
Policy Research Institute

The Financial Services Agency of Japan recently published a "Report of the Working Group on Capital Market Regulations and Asset Management Task Force of the Financial System Council" (the "Report"), which describes a strategy for improving the capabilities of asset management companies who are playing important roles in managing financial assets and making returns for households. The strategies include promoting a virtuous cycle of growth and asset-based income in the investment chain through enhancing fund-raising for startups and feeding those returns back to households, and promoting initiatives for achieving a leading asset management center.

This newsletter discusses the section of the Report on "Product Governance" and "Rectifying Japan's unique business practices in investment trusts". While the contents of the Report are not indicative of an imminent change in the law, we believe that the statements will have an impact on practice.

1. Product Governance

Certain measures have been taken by asset management companies, such as establishing product governance committees, and the Investment Trusts Association also has taken initiatives towards improvement of investment trusts, which promotes product governance. However, issues continue to be pointed out regarding product governance in asset management companies, including the provision of information that is easy for clients to understand, such as:

・During the process of developing products, there may not be sufficient verification regarding the setting of appropriate assumed customer attributes or the setting of appropriate trust fees that match the operational costs.

・After product composition, there may not be sufficient verification on whether asset management is being conducted as expected, or whether asset management is continuously suitable for the corresponding product.

・Sufficient verification is not conducted with regard to sales conditions where sales companies sell financial products and the procedures for the sale of financial products may not be suitable for the assumed customer attributes.

・Regarding the provision of information that is easy for customers to understand, there may be room for improvement in how information is provided to customers regarding product attributes, including assumed customer attributes and costs, which aids in the appropriate selection by customers.

・The transparency of the asset management system, such as the disclosure of names of the individual asset managers, has not been progressing, possibly leaving customers unable to invest with confidence due to the lack of understanding of the operational reality. Enhancing the transparency of the operational system, including the disclosure of individual asset managers' names, could foster a sense of responsibility of asset management towards investors.

・Asset management companies should tackle with desirable disclosure comparable and visible to other asset management companies so that investors can make appropriate product selections through evaluations by fund analysts and investment advisory firms.

・As for governance system issues, it is necessary to improve governance at the management level of asset management companies.

・With regard to alternative investments, more sophisticated management than traditional securities operations is required.

・An appropriate governance system is required in selection of schemes and examination of sales targets based on the risks of investment objects and methods.

Based on these points, it is appropriate to add descriptions centered on product governance to the principles of client-oriented business operations and to establish a governance system for quality control of individual products in asset management

companies to support proper product composition and management, and ensure transparency.

2. Rectify Japan's unique business practices in investment trusts

Currently, the net asset value (NAV) of investment trusts is calculated daily by both the management company (asset management company) and the trustee company (trust bank), a practice known as double-check calculation. Double-check calculation has contributed to beneficiary protection by enhancing the fairness of the NAV evaluation through a mutual restraining function. However, with advancements in information technology and the progression of global competition, there are concerns that double-check calculation, as a unique business practice in Japan, may be adding additional costs to investors and may be a barrier to entry.

To implement single calculation, challenges include the need for changes in business flow and system adjustments at asset management companies, as well as the need for clarification of the materiality policy regarding NAV calculation errors. The materiality policy for investment trusts refers to a policy of correcting the NAV when errors exceed a certain significant (material) level. This is intended to prevent the cost associated with retrospectively correcting minor calculation errors from being passed on to all investors and to ensure an appropriate level at which errors are corrected.

Materiality policies are set by internal regulations at each asset management company, with the level for correcting the NAV generally at around 0.5% (50 basis points), but there is variation among companies, and the policy is not widely communicated to investors. For the realization and adoption of single calculation, standardization and unification of business processes within the industry are considered necessary.

For the clarification of the materiality policy, when setting such a policy, it is appropriate to specify in regulatory guidelines the need for an appropriate level and the importance of making the policy known to investors. Since the decision to correct the NAV affects investors, it is desirable for each company to define its approach to

setting levels under the involvement of management and to communicate this to investors.

This report states this approach not only ensures a certain level of investor protection but also allows new entrants to understand the level that should be set as a materiality policy, potentially lowering barriers to entry and promoting entry into the investment management business.

Authors/Contacts

Takafumi Ochiai
Atsumi & Sakai
Head of Policy Research Institute
E: takafumi.ochiai@aplaw.jp

Kenichi Tanizaki
Atsumi & Sakai
Deputy Head of Policy Research Institute
E: kenichi.tanizaki@aplaw.jp

Tatsuhiro Hirayama
Atsumi & Sakai
Policy Research Institute
Senior chief researcher
E: tatsuhiro.hirayama@aplaw.jp

If you would like to sign up for Policy Research Institute Newsletters, please fill out the sign-up form.

Back issues of our newsletters are available here.