NRI Dream up the future.

# lakyara

2012

Kyara, which means "precious" in ancient Japanese,
is an aromatic resin regarded as the highest quality of all agarwood.
"lakyara [la-kǽla]" aims to deliver the same quality as Kyara together with
NRI's endeavour for continuous excellence and innovation to provide
the most advanced and up-to-date information to our readers worldwide.

vol.136 (28.March.2012)

# The AIJ scandal and regulation of investment managers

Nomura Research Institute, Ltd.

## Introduction

The revelation that AIJ Investment Advisors is unable to account for 90% of the pension fund assets it manages has shocked the Japanese public. With the facts not yet fully known, it may be premature to comment on this scandal without inviting criticism.
However, the ruling Democratic Party and Financial Services Agency (FSA) have apparently already started discussing regulatory reforms in response to accusations that deficiencies in Japan's corporate pension system and regulation of investment managers are partly to blame for the AIJ scandal. Following are my personal views on regulation of investment managers and related issues based on media reports of the facts of the scandal and regulatory reforms reportedly under discussion (or likely to be discussed).

## AIJ Ponzi scheme

First, the AIJ scandal clearly involves fraud. Although it is too early to conclude that AIJ's misdeeds constitute criminal fraud, discussion of regulatory reform must be based on recognition of very strong elements of fraud. Specifically, AIJ solicited funds from customers by presenting falsified records of its investment performance.

AIJ has misrepresented its investment performance since shortly after if not as soon as it began managing pension assets in 2002. It apparently avoided detection of its misdeeds by using inflows of cash from new clients to meet redemptions from existing clients as if its purported returns were authentic. In other words, AIJ was running a Ponzi scheme[1], a relatively common form of fraud even in US and European financial and capital markets.

The most infamous Ponzi scheme is Bernard Madoff's $18 billion fraud uncovered by the US Securities and Exchange Commission (SEC) in December 2008, but the SEC's website lists 32 Ponzi scheme cases discovered in 2009–11 alone.

Incidentally, Mr. Madoff's Ponzi scheme deceived many market participants, including international financial institutions and major institutional investors, for over 20 years. It was discovered only when Mr. Madoff was no longer able to meet clients' redemption requests. One hallmark of Ponzi schemes is long-term sustainability even though their modus operandi is often revealed to be unsophisticated in hindsight.

In the wake of the Madoff scandal, the SEC was heavily criticized for lax regulation and oversight, largely because it had failed to discover the Ponzi scheme earlier[2]. In response, the US implemented various regulatory reforms, mainly to strengthen oversight of asset managers. Drawing lessons from the US experience, I discuss below a number of regulatory reforms likely to be proposed in Japan.

## Strengthening inspections and oversight

One such reform is intensification of inspections and oversight of asset managers. The improprieties at AIJ were discovered during an inspection by the Securities and Exchange Surveillance Commission (SESC). This inspection was reportedly the first ever conducted at AIJ since it began operating as a discretionary investment advisor. In light of such, it is reasonable to believe that investor losses could have been mitigated if AIJ had been inspected sooner.

That said, it would be premature to conclude that the existing inspection and oversight regime has major deficiencies. The SESC discovered improprieties relatively soon after beginning its inspection of AIJ and the FSA's Kanto Local Finance Bureau ordered AIJ to cease operations without waiting for the inspection to be completed. Given that the inspection was prompted by suspicions reported by outsiders and AIJ was not even on the investment community's radar until November 2008, when it became the first non-major firm to be named the most popular asset manager in a rating agency survey, the SESC and FSA cannot be accused of being slow to act. On the contrary, the Japanese authorities should be commended for acting promptly and decisively in contrast to the US SEC's performance in the Madoff case.

To increase the frequency and quality of inspections of asset managers, the authorities would have to hire additional inspectors and gain know-how different from that used in bank and brokerage inspections, which have hitherto accounted for the bulk of financial inspections. However, with government finances now in critical condition and the national government considering major cutbacks in hiring, the authorities cannot realistically seek to simply step up inspection and oversight of asset managers. To some extent, the authorities have already been preferentially allocating resources to inspections of asset managers deemed to be high risks based on information from various sources, including internal whistleblowers. This approach should ultimately lead to early detection of improprieties and containment of client losses[3)].

Another approach worth considering is greater utilization the capabilities of self-regulatory organizations (particularly the Japan Securities Investment Advisers Association (JSIAA)) to intensify inspections and oversight of asset managers. However, in deciding whether to rely more on self-regulation, the authorities must not overlook the fact that not all discretionary investment advisors are members of a self-regulatory organization.

## Market entry regulations and internal controls

Another issue likely to come up in the reform debate is the proper approach to internal controls and regulation of entry into the discretionary investment advisory business. Between March 2001 and September 2011, the number of JSIAA-member discretionary investment advisors roughly doubled from 126 to 246 companies[4)]. While this growth is largely attributable to expansion of the size of the investment management "pie" due to growth in pension assets[5)], another contributing factor is deregulation in conjunction with enactment of the Financial Instruments and Exchange Act (FIEA) in 2006. This deregulation included replacing the previous licensure system with a registration system to regulate entry into the discretionary investment advisory business. Additionally, specialized (e.g., venture capital) fund managers that were previously unregulated became subject to regulation as investment managers.

Among financial businesses, investment management has a relatively low barrier to entry. Opening an investment management business does not require much capital investment or personnel if one possesses sufficient asset management expertise. In the alternative investment (e.g., hedge fund, VC fund) arena in particular, quite a few talented fund managers have expanded the asset management business's horizons solely by dint of their individual skills and expertise and developed a clientele through their own personal connections. In light of such success stories, doubts arose about the wisdom of imposing uniform minimum capital requirements on all asset managers during the legislative amendment process leading up to the FIEA's enactment. The FIEA consequently includes a provision (Article 63(1)) that allows individual fund managers to start their own business simply by filing the requisite paperwork, provided that their clientele is limited to qualified institutional investors.

Although subsequent entrants to the investment management business undoubtedly included some unscrupulous operators like AIJ, they have also spurred competition that has undeniably contributed to diversification and advancement of asset management techniques and improvement in investment performance. The authorities must avoid tightening restrictions on market entry as a knee-jerk reaction to the AIJ scandal, lest they deny market access to upstanding, innovative fund managers that operate on a small scale[6)].

Given the long duration of the fraud perpetrated by AIJ, its internal controls and governance by its directors and auditors were undoubtedly deficient. However, AIJ's deficiencies in these areas do not justify stricter regulation of all investment managers' internal controls and governance. Such regulation would likely accomplish nothing more than burdening honest investment managers with excessive regulatory costs. Fundamentally dishonest investment managers are usually adept at maintaining an appearance of propriety. Unfortunately, there are also unethical accountants, attorneys, tax accountants, consultants, and others willing to cooperate with such fraudulent operators. The authorities must avoid regulatory reforms that merely impose undue costs on honest operators without preventing fraud.

## Tightening of investment restrictions

A third reform that may be proposed is restrictions on how investment managers can invest client funds and regulation of investment of pension assets. Because AIJ used private funds domiciled in the Cayman Islands, there are major concerns about such investment vehicles, as evidenced by recent criticism of them and skepticism toward the alternative investments of which AIJ was a proponent.

Investment management firms sometimes choose to set up overseas funds, including in the Cayman Islands, to take advantage of lower startup costs or local trust laws' flexibility, not necessarily to conceal improprieties. Tax efficiency (not tax evasion) is another practical consideration that cannot be overlooked. For professional investors such as pension funds, private funds are an extremely common form of investment vehicle. Private funds themselves should not be viewed with suspicion. AIJ's conduct was fundamentally fraudulent. Even if AIJ had not been a proponent of alternative investments or utilized Cayman-domiciled private funds, it would still have been able to perpetrate its fraud[7].

In light of the AIJ scandal, some commentators have said that pension funds do not qualify as professional investors in reality. There have even been media reports that the authorities are rethinking pension funds' status as professional investors. However, the question of whether a certain class of investors should be legally classified as professionals should not be determined solely based on whether individual pension fund administrators are knowledgeable about asset management. Pension funds fulfill the important responsibility of safekeeping and appropriately investing corporate pension contributions for the benefit of pension plan participants and other beneficiaries. Given that pension funds invest third parties' assets and are compensated for doing so, they are unquestionably professional investors irrespective of the skills and qualifications of the individuals employed to actually administer the pension funds.

Even if there are legitimate doubts about whether pension funds in their current state qualify as professional investors, the proper response would be to promote a higher degree of professionalism among pension funds, not treat them as unsophisticated investors[8].

Another idea that has been suggested is restricting pension funds' asset allocation to alternative investments, a proposal reminiscent of the old 50:30:30:20 asset allocation rule. However, adoption of such a one-size-fits-all regulation is unlikely to have any effect preventing fraud. Indeed, it would merely constrain sophisticated pension funds' ability to improve their investment returns. Restricting legitimate investment in alternative asset classes to prevent losses caused by fraudulent operators such as AIJ would be severely counterproductive[9].

## Reporting and disclosure requirements

A fourth reform that may be considered is expanding investment managers' reporting and information disclosure requirements and/or having trust banks become more involved in monitoring their investment activity. While such an approach should not be rejected out of hand, the authorities should proceed very carefully with any such measure, lest it imposes an onerous administrative burden that drives small investment management firms out of business or leads to a decrease in new entrants. As mentioned above, fundamentally dishonest operators are adept at preparing ostensibly authentic reports and disclosure documents and finding professionals willing to aid and abet them, albeit not necessarily with full knowledge of their illegalities. The authorities must recognize that even if they revise reporting or disclosure rules, such changes alone are unlikely to eliminate improprieties.

Enlisting trust banks in their capacity as custodians of pension fund assets to monitor investment activity for improprieties is an idea worthy of consideration in some respects, but I doubt that such an approach would be very effective. If a pension fund invests in assets such as private funds and structured (e.g., securitized) products and the party that structured or manages the product commits fraud in collusion with the investment manager that makes the investment decisions, such fraud would be difficult for even a trust bank to detect, even if it is highly diligent. Another suggestion is enlisting trust banks to monitor the content of investment managers' investment directives, but it is not reasonable to ask a trust bank acting as asset custodian to meddle in the investment decisions of a professional investment manager[10].

## Conclusion

To reiterate, the AIJ scandal is a case of fraud. It does not involve deficiencies in risk management or asset custody, inadequate information disclosure, or other such elements. Fraud committed boldly is extremely difficult to prevent through regulation. What is most essential to minimize losses from fraud and prevent recurrence is to detect improprieties as early as possible and severely penalize the perpetrators[11]. If some type of regulatory reform is implemented in response to the AIJ scandal, I strongly hope that the reforms adequately reflect recognition of this point.

Some have noted that the large amount of pension assets that AIJ managed is indicative of various problems with corporate pension plans' operation, including underfunding of multiemployer pension funds and difficulty earning adequate investment returns. Not having sufficient knowledge of pension plans, I have refrained from commenting on such matters. However, if some type of pension reform is implemented, I hope the reforms are realistic and truly effective.

### Note

1) Named after Charles Ponzi, who perpetrated a large-scale fraud of this type in the 1920s. In Japan, Ponzi scheme is sometimes mistranslated as *nezumiko* (pyramid scheme). A pyramid scheme differs from a Ponzi scheme in that investors in a pyramid scheme collect a share of the money invested in the scheme by new investors that they themselves have recruited.

2) From 1992, the SEC received many reports of suspicions regarding Mr. Madoff's fund but failed to discover the fraud despite having conducted three on-site audits of the fund. As a result, there was speculation that SEC personnel intentionally overlooked improprieties.

3) In the US, post-Madoff regulatory reforms included greater cooperation with internal whistleblowers.

4) The FSA is currently conducting a blanket investigation of 265 discretionary investment advisors. This number differs from the JSIAA membership number because not all discretionary investment advisors are JSIAA members.

5) Pension assets managed by investment managers more than doubled from ¥42.1 trillion as of March 31, 2001, to ¥86.4 trillion as of March 31, 2011.

6) In response to the AIJ scandal, some pension funds are reportedly rethinking asset management mandates awarded to independent investment managers. While AIJ was in fact an independent company unaffiliated with any financial institution group, such suspicion of independent investment managers in general is irrational.

7) AIJ's advocacy of alternative investments instead of conventional asset classes like Japanese equities undeniably imparted a certain degree of credibility to its anomalously high investment returns. However, a similar Ponzi scheme that purportedly invests in Japanese equities, foreign equities, or bonds is by no means inconceivable.

8) In terms of promoting professionalism, the authorities must devise realistic measures that take into account that management of pension fund assets broadly entails four processes: (1) actuarial determination of pension contributions, (2) determination of an asset allocation based on contribution amounts and a target rate of return (actuarially calculated discount rate), (3) selection of external managers for each asset class, (4) and asset management by the selected fund managers. Pension funds themselves typically do not select the specific securities in which they invest or execute trades in those securities (when a pension fund performs these functions itself, the model is called in-house management). Accordingly, it is essential to recognize that the qualities that make a good pension fund administrator are not necessarily the same as those sought in a fund manager. The AIJ scandal has drawn scrutiny to the fact that pension funds employ many retired Social Insurance Agency officials, but the argument that former Social Insurance Agency employees are unqualified to work for a pension fund because they have no experience actually trading stocks or bonds is not valid.

9) The idea of restricting the percentage of assets managed by any one management firm is also highly dubious because virtually any

investment management firm is capable of offering balanced funds that are amply diversified. Pension fund should be allowed to decide for themselves how to achieve adequate diversification. One-size-fits-all rules are inappropriate.

10) In the US, post-Madoff regulatory reforms include a requirement that account statements be sent directly to clients from the custodian of the client's assets if the client's assets are in the custody of a qualified custodian selected by the investment manager instead of a trust bank or other custodian designated by the client (amendment of Investment Advisers Act Rule 206(4)-2). This reform was a response to the fact that Mr. Madoff's Ponzi scheme went undetected for many years because his fund mailed account statements directly to clients. However, it is doubtful whether such a requirement would adequately prevent fraud perpetrated through utilization of private investment funds à la the AIJ case.

11) Bernard Madoff is currently serving a 150-year prison sentence.

Author's Profile

Sadakazu Osaki

Head of Research
Center for Strategic Management and Innovation

E-mail : kyara@nri.co.jp



Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara