MASON HAYES & CURRAN

How Irish Regulated Hedge funds can help eliminate AIJ-type Investment Scandals

May 2012

Revelations that AIJ Investment Advisers Co. ("AIJ") may have lost substantially all of the client monies it managed, despite claiming high returns for years, have naturally raised concerns among investors and in particular those investing in hedge funds or other alternative investment products.

After outlining some of the key elements of the alleged fraud, this article explores how various requirements imposed by the applicable regulatory regime should help minimise or eradicate the risk of this type of fraud for Irish regulated hedge funds.

Background[1]

AIJ had been hailed back in 2008 as a leading pension management firm in a survey by Rating & Investment Information Inc. due to its "stable performance" amid volatile markets[2]. However, it was suspended by Japan's Financial Service Agency from carrying on business in late February of this year while an investigation was carried out into its operations[3]. This revealed that its claims to have produced consistently high returns for investors[4] on the up to $2.62 billion[5] in client money it managed on behalf of a reported figure of 92 pension funds representing some 880,000 employeeswere false and in fact it may have lost up to 90% of the assets under management[6].

AIJ was appointed as investment manager with discretionary powers to Cayman domiciled funds, being the AIM Global Fund and the AIM Millennium fund (the "AIJ Offshore Funds"). It claimed to be carrying out an alternative investment strategy using options on the Nikkei 225 and other financial derivative instruments that allowed it to achieve positive returns even when the underlying markets it traded in relation to were negative.

However, Kazuhiko Asakawa, one of the principals of AIJ, had established AIM Investment Advisors Ltd. (AIA), a fund management company registered in the British Virgin Islands to act as manager to the AIJ Offshore Funds. Ownership of AIA was transferred to AIJ around 2005 with Asakawa remaining in control as a director.

AIA evidently reported false net asset values regarding the AIJ Offshore Funds[7]. Investors were reported to be unaware of the connection between AIA and AIJ and in fact AIA received a total of 4.5 billion yen in management fees from the AIM Millennium fund alone between March 2003 and March 2011[8]. The allegedly false reports[9] were apparently issued directly to some investors and also through a placement agent, ITM Securities Co. Ltd (ITM). However, ITM in turn appears also to have been under the control of AIJ as it is reported that it was substantially owned through two Japanese companies controlled by AIJ, Sigma Capital and Diversified Strategy, which owned over 80% of its shares[10].

It is evident from the available reports that the unexpected losses incurred by AIJ stem from falsification of fund performance reports and this

1 The facts as set out reflect those reported in a wide variety of media publications, including those specifically listed below. As this is an on-going case new facts will continue to emerge following further investigations and subsequent editions of this article will be adopted to reflect such updates.

2 "AIJ: Pension Fund Manager of the Year?", Kenneth Maxwell, Wall Street Journal Japan, February 24, 2012

3 "AIJ Beckoned Japan Pensions With 50-Year-Old Return Targets", Tomoko Yamazaki and Komaki Ito Bloomberg News, March 22, 2012

4 "AIJ Fund Reported 241% Return since 2002 on Options Bets", Tomoko Yamazaki and Komaki Ito, Bloomberg, February 27 2012

5 "Money Fund in Japan Told to Halt Operations", The New York Times, Hiroko Tabuchi,, February 24, 2012

6 "Japan Looks Abroad for AIJ Funds", Kana Inagaki, Wall Street Journal, March 1, 2012

7 "The importance of being Diligent. Case Study: AIJ", Sus Volans, April 2012

8 "Asakawa Received Huge Payoff in Dividends from AIJ Affiliate " The Japan Times, April 24, 2012

9 "3rd UPDATE: Japan Regulators Allege AIJ Hid Losses For Nearly A Decade", The Wall Street Journal, Kana Inagaki, Marh 23, 2012

10 "The importance of being Diligent. Case Study: AIJ", Sus Volans, April 2012

has now been publicly admitted by Asakawa[11], although intentional fraud has been denied[12].

With this series of facts as the background, we will now turn to examine Ireland as an alternative domicile for international funds and how its regulatory requirements might have assisted in preventing this affair.

Irish funds – a brief overview

Ireland is a leading European domicile for investment funds. There is currently over €1 Trillion held in some 5,000 Irish domiciled funds, 98% of which have international sponsors. Over 30% of all cross border European funds are based in Ireland[13] and it is home to 63% of European alternative funds[14].

Irish funds can be broadly divided into UCITS and non-UCITS structures. UCITS (Undertakings for Collective Investment in Transferable Securities) are funds established pursuant to pan-European Directives as implemented in each Member State of the European Union (the "EU")[15]. The primary advantage of obtaining authorisation under UCITS is that once authorised as such the fund obtains a "passport" and it is possible to distribute such funds throughout the EU without being required to obtain additional authorisations. UCITS are also increasingly recognised internationally due to their high level of investor protection, with 40% of all new sales occurring in the Far East in recent years. The range of investment restrictions applicable to UCITS meant that they previously only pursued traditional investment strategies, but following the adoption of a range of reforms known as "UCITS III"[16] alternative UCITS, often referred to as "newcits", began to emerge to take advantage of the broader investment parameters afforded them and this trend has gathered pace following the financial crises of 2007-2008 with over 1,000 such funds having now been launched to date.

Irish UCITS experienced the highest net inflows of any fund domicile during 2011 following its successful adoption of the new "UCITS IV" regime[17]. Ireland attracted net inflows of some €50 billion more than the next most successful domicile and bucked a trend that saw most domiciles experiencing large fund outflows. Furthermore, Ireland's share in the overall UCITS market increased by 26% since the beginning of 2011. In the fourth quarter of 2011 alone, Irish UCITS attracted five times more new monies than those of all other jurisdictions combined[18].

Non-UCITS structures are established in Ireland pursuant to domestic Irish legislation. The most popular form of non-UCITS fund is the Qualifying Investor Fund, ("QIF"), which is the primary European hedge fund vehicle and, as it is aimed at sophisticated investors, it is largely exempt from the general investment and borrowing restrictions of the Irish regulator, the Central Bank of Ireland (the "Central Bank"). However as it remains a regulated type of fund the relevant structural safeguards, discussed below, are applicable. In addition, interest in the QIF is likely to see strong growth in the coming years as such funds are largely automatically compatible with the requirements of the Alternative Investment Fund Manager's Directive (the "AIFMD")[19] and this will grant a potential new pan-EU passport for non-UCITS alternative funds from 2013.

Key reasons behind the strength and continued growth of the funds industry in Ireland include: the robust on-going regulation of the sector, the level of accumulated specialised experience, the increased competitiveness of the Irish economy and the attractive range of fund products available under the Irish regulatory regime, which include both UCITS and QIFs.

This article will briefly explore some of the additional safeguards provided for in relation to Irish funds which could have assisted in preventing an AIJ type scenario.

Appointment of a Trustee

The requirements of the Central Bank provide that all the assets of an Irish fund must be entrusted to an appropriately licenced and authorised third party trustee for safe-keeping. Where the trustee proposes to discharge its related obligations through a separate third party, that third party must be appointed as a sub-custodian by the

---

[11] "AIJ's Asakawa Says He Falsified Fund Performance Reports", Bloomberg, Tomoko Yamazaki, March 27, 2012. "AIJ head's Diet apology skips how cash vanished"; The Japan Times; Hiroko Nakata, March 28, 2012; "AIJ Falsified Reports, Tax Prosecutors, Swaps: Compliance", Bloomberg, Carla Main, March 28, 2012.

[12] "AIJ president denies fraud in upper house testimony", Jiji Press, April 4, 2012

[13] "Statistics", Irish Fund Industry Association, March 2012

[14] HFR survey, 2010

[15] The current UCITS Directive (Directive 2009/65/EC- also known as "UCITS IV") was transposed into Irish law by way of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (SI 352 of 2011).

[16] Directive 2001/107/EC and Directive 2001/108/EC are collectively referred to as UCITS III. This regime has more recently been surpassed by "UCITS IV" discussed below and at Footnote 15.

[17] Directive 2009/65/EC. See also Footnote 15 above.

[18] "Annual Statistical Report", European Fund and Asset Management Association (EFAMA), February 2012

[19] Directive 2011/61/EU

trustee[20]. It can be noted that there are specific prohibitions on a trustee having directors in common with the board of a management company it provides services to, as was the case between AIJ and AIA, the manager and investment managers respectively of the AIJ Offshore Funds. The involvement of such an independent party assists minimise the potential for misstatements or fraud and to ensure that where this does occur it should be picked up at an early stage.

In addition to holding relevant assets, trustees are subject to a range of positive duties towards the funds they act in relation to under Irish law. These include a requirement to ensure that the sale, issue, repurchase, redemption and cancellation of units effected on behalf of a fund are carried out in accordance with the terms of the scheme and applicable law and that the fund's income is applied appropriately. This later requirement should limit the potential for dividends to be paid from false profits, the classic hallmark of a Ponzi scheme.

Trustees are placed under a positive obligation to enquire into the conduct of funds and their management companies and to make a formal report thereon to the unitholders. Where compliance issues are identified the trustee must identify them and outline the steps which it has taken to rectify the situation. The trustee must notify the Central Bank promptly of any material breach of relevant legislation, regulatory requirements or the terms of the offering documentation.

Trustees must exercise due care and diligence in the discharge of their duties under the relevant regulatory framework and will be required to accept liability for any loss arising from "negligence, fraud, bad faith, wilful default or recklessness in the performance of those duties" towards QIFs, or in the case of UCITS for the "unjustifiable failure to perform its obligations or its improper performance of them". It is not possible to contract out of these obligations and it is unlikely that the terms of any custodian agreement not required by law to include such terms and liability would do so. Accordingly, even in cases where an offshore fund appoints a custodian, or is structured as a unit trust[21], and therefore has a trustee, it is unlikely that they will be subject to the same level of obligations, liability or reporting requirements as would be the case if it were an Irish domiciled fund.

Finally, it can be noted that even where an underlying fund is domiciled outside Ireland, because the activity of the trustee is regulated in Ireland the Central Bank may request information on non-Irish schemes in order to effectively perform its role as supervisor of Irish service providers and Irish custodians are required to submit quarterly returns containing relevant information on the funds they service.

Fund Governance Requirements

The recent Weavering case[22], where two "independent" directors with relatively little relevant experience were subject to civil litigation for their conduct as directors of a Cayman fund structured as an investment company, has focussed increased attention on the nature and composition of fund boards and their management companies. In the AIJ case it appears that false NAVs were issued by or on behalf of AIA, which Asakawa was a director of.

Irish funds, or their management companies, are required to have a minimum of two Irish resident directors and every director is required to obtain approval from the Central Bank and to meet its fitness and probity standards. The fitness and probity standards extend to those in control functions in regulated financial institutions. Separately, the new Irish voluntary Corporate Governance Code for funds[23] provides for the appointment of at least one entirely independent director as well as a representative of the investment manager. While this code is not compulsory as yet, it operates on a "comply or explain" basis so a failure to appoint an independent director can act as a red flag to investors when carrying out due diligence or signal the need for additional inquiries.

The Central Bank requires directors to disclose to their boards any concurrent directorships they hold in relation to funds or fund service providers to assist in identifying conflicts of interest.

The issue of director capabilities and experience has greater significance in the context of UCITS as, in addition to general director's duties, the boards for such funds, or their management companies, are specifically required to take responsibility for ten key management functions under the current UCITS regime, including risk management, supervision of delegates and monitoring of investment policy, investment strategies and performance, for example. Each

20 These requirements create potential issues in relation to the appointment of prime brokers to Irish authorised funds. See "Prime Broker Appointment" below for further information.

21 For example the AIM Millennium fund was structured as a unit trust

22 Weavering Macro Fixed Income Fund Limited (in liquidation) v Stefan Peterson and Hans Ekstrom, Cayman Islands Grand Court, Financial Services Division, 2011

23 The voluntary "Corporate Governance Code for Collective Investment Schemes and Management Companies" as issued by the Irish Funds Industry Association

management company or self-managed fund is required to prepare a "business plan" which details the manner in which these requirements are met on an on-going basis and the UCITS' "Statement of Responsibility" will specify which specific responsibilities adhere to each director. Again, this should assist in clearly identifying any potential conflict of interest.

Promoter and Investment Manager Approval Process

It can be noted that in order to establish an Irish regulated fund it is necessary for the sponsor, or promoter, to be approved by the Central Bank and to meet its criteria, which include a minimum capital requirement and an expectation that it will be regulated in its home jurisdiction.

In addition, in order to act as the investment manager of an Irish fund, regardless of whether it was set up by that entity or some third party promoter, it is necessary for an entity to receive the prior approval of the Central Bank, even if they are located overseas. The Central Bank will expect potential investment managers to be regulated in their home jurisdiction and investigates their regulatory status with overseas regulators as part of the approval process. Accordingly, there is potentially a two-fold level of regulatory oversight where non-EU managers are appointed to Irish funds. AIJ, which was originally established in 2000 under the name AIM Asset Management, did not originally have the requisite licence to provide discretionary asset management to funds in Japan[24] and as such it should not have been possible for that entity to proceed to establish an Irish fund in the first place.

Disclosure of ownership is also required in the application for investment management approval process and, in addition to providing a means to prevent inappropriate persons from obtaining positions of influence on the management of funds from behind a corporate veil, this also assists in identifying conflicts between the relevant parties. These requirements apply to both UCITS and non-UCITS funds.

Prime Broker Appointment

The fact that AIJ did not appoint prime brokers to its funds has been highlighted as an indicator of likely fraud given the volume of transactions contemplated under its purported investment strategy[25]. There is no obligation for Irish regulated funds to appoint a prime broker, but where they do wish to use prime brokerage services then this must be fully disclosed in the fund's offering documentation and accord with relevant regulations. For example, for QIFs, the terms of the appointment must accord with the requirements of the Central Bank as set out in Guidance Note 2/11 "Professional collective investment schemes: Appointment of prime brokers and related issues" (the "Guidance Note").

The terms of the Guidance Note seek to protect funds from counterparty risk in the event of the insolvency of the prime broker, particularly if it were to be appointed under their standard terms. Under its terms QIFs may select and enter into relationships with prime brokers which are regulated to provide prime brokerage services by a recognised regulatory authority, and which (or whose parent company) must have shareholders' funds in excess of €200 million and a minimum credit rating of A-1 or equivalent.

Such arrangements may include provisions whereby the prime broker may pledge, lend, rehypothecate or otherwise utilise for its own purposes fund assets transferred to it ("relevant assets"), without being appointed as a sub-custodian, in certain limited circumstances.

It is also a requirement that provisions be put in place to ensure compliance with the relevant requirements and the trustee will generally be responsible for monitoring compliance on an on-going basis, all of which adds additional safety to such funds. Finally, it is a requirement that such agreements be filed with the Central Bank along with necessary legal confirmations of regulatory compliance.

Summary

While the risk of fraud can never be completely eliminated, the use of certain structures and contractual arrangements can help prevent specific types of fraud and reduce the overall potential risk. Irish regulated fund structures afford investors greater comfort due to their built in additional safeguards which include: maintaining set criteria for entities wishing to act as fund sponsors or promoters; requiring fund assets to be entrusted to a licenced third party custodian with specific duties and obligations; and applying on-going governance standards to the management of Irish authorised funds.

[24] "The importance of being Diligent. Case Study: AIJ", Sus Volans, April 2012

[25] "The importance of being Diligent. Case Study: AIJ", Sus Volans, April 2012

About the Author

Mark Browne is a Partner in Mason Hayes & Curran specialising in investment funds. Mark has over 12 years' experience in the funds industry and advises on all aspects of the structuring, establishment and on-going operation of investment funds, as well as in regard to issues affecting service providers such as administrators, custodians, distributors and investment managers. Mark practised as an Attorney-at-Law specialising in hedge funds in the funds practice of a leading firm in the Cayman Islands for four years and advises on the re-domiciliation of offshore funds to Ireland and the restructuring of hedge funds as UCITS. He previously worked in the investment funds department of another large Irish firm and for a leading global custodian in Luxembourg and is an affiliate of the Association of Certified Chartered Accountants.

He is a regular contributor to financial journals and has lectured on hedge fund frauds including in relation to the Weavering and Madoff cases. He is recommended by Legal 500 in the Investment Funds Category.

Mark Browne
Partner,
Investment Funds
DDI: +3531 614 5866
Email: mbrowne@mhc.ie

About Mason Hayes & Curran

Mason Hayes & Curran is a leading Irish full service law firm with 65 partners, over 270 employees and offices in Dublin, London and New York.

The dedicated Investment Funds Practice at Mason Hayes & Curran advises on all aspects of investment funds law and regulation including structuring, establishing and the on-going operation of investment funds in Ireland, as well as due diligence for potential investors into existing funds. In particular, we have significant experience of advising international investment managers and promoters on the authorisation process with the Central Bank and then on establishing Irish domiciled UCITS and QIFs for international distribution, both within Europe and further afield.

As a full service law firm the Investment Funds Practice is further supported by the broader Investment Funds Group at Mason Hayes & Curran which includes specialist practitioners from the Tax, Corporate, Dispute Resolution, Banking, Intellectual Property, Employment and Financial Services Regulation Practices who have experience of applying their specialisations to the funds industry. This allows us to ensure specialised advice in relation to all relevant matters affecting both funds and their management companies which chose to domicile in Ireland.

Dublin
South Bank House
Barrow Street
Dublin 4
Ireland

t +353 1 614 5000
e mail@mhc.ie

London
60 Lombard Street
London
EC3V 9EA
United Kingdom

t +44 20 3178 3368
e mail@mhcldn.com

New York
330 Madison Avenue
6th Floor, New York
NY 10017
USA

t +1 212 786 7376
e mail@mhcny.com