JAPAN PUTS FORTH BOLD LEGISLATION TO ATTRACT MORE FOREIGN ASSET MANAGERS TO UPGRADE GLOBAL FINANCIAL CENTER STATUS IN POST-COVID-19 WORLD

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Asset Management and Investment Funds Alert

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Japan is making bold policy and legislative actions to reshape its regulatory landscape for the asset management industry, aiming to invite more foreign asset managers to Japan and further elevate Japan's status as a global financial center in a post-pandemic world. In particular, Japan has announced two new licensing exemptions designed primarily to incentivize foreign fund managers to open offices in Japan to be effective as early as the end of 2021. This alert provides key takeaways about these initiatives that we know thus far and what we expect to happen next.

BACKGROUND – JAPAN'S INTERNATIONAL FINANCIAL HUB INITIATIVE IN FULL ACTION

Since the fall of 2020, under the leadership of Commissioner Ryozo Himino, the Financial Services Agency of Japan (the FSA) announced that it will take a number of policy actions to set the stage for strong post-COVID-19 growth,[1] which was included in the Suga Cabinet's broader economic policy issued in December 2020.[2] These policy and legislative actions in connection with the asset management industry range from:

1. Tax reforms, which include favorable changes effective as of 1 April 2021 to corporate tax, income tax, and inheritance tax for asset management firms and their employees;[3]
2. Launch of the “Financial Market Entry Office,” which provides “one-stop” (a) English consultation and assistance services to foreign asset managers planning to register with the Japanese regulator, and (b) supervision over these firms using the English language;[4]
3. Immigration reform for highly skilled professionals; and
4. Introduction of two types of new licensing exemptions that are expected to be used primarily by foreign asset managers.[5]

On 5 March 2021, the Suga Cabinet submitted an omnibus bill with the National Diet (the Proposed Bill), which included amendments to the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended) (the FIEA) to provide the licensing exemptions for the benefit of foreign asset managers that intend to open offices in Japan. These new types of licensing exemptions are based on the policy recommendations issued by

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the Working Group on Capital Market Regulations of the Financial System Council in December 2020 (the Policy Recommendation).[6]

TWO LICENSING EXEMPTIONS UNDER CONSIDERATION

The Proposed Bill provides:

5. An exemption from Type II broker-dealer and investment management registration for fund operators of certain partnership-type funds (which have "primarily" foreign investors) when offering certain eligible partnership-type funds and managing assets invested in those funds (the Foreign Investor Fund Exemption);[7] and
6. An up to five-year registration moratorium for foreign managers registered with a foreign authority who have foreign investors only and who satisfy certain eligibility requirements (the Registration Moratorium).[8]

The Proposed Bill is expected to pass during the current 204th Diet Session, currently scheduled to conclude on 16 June 2021. The Proposed Bill provides that, if adopted by the National Diet, the amendments to the FIEA be implemented at a date designated by the FSA, but no later than six months from the date of promulgation. In other words, this new preferential treatment could become available as early as the end of 2021. The Proposed Bill also includes a provision requiring the government to review the status of implementation in five years and take necessary actions, which leaves the possibility of the government taking additional actions in the future.

PROPOSED FOREIGN INVESTOR FUND EXEMPTION

Generally, to engage in solicitation of, or offering, a partnership-type fund, a fund operator would be required to be registered as Type II broker-dealer and investment manager with the FSA under the FIEA. The proposed Foreign Investment Fund Exemption would exempt these registration requirements from the fund operator if (a) the fund operator satisfies certain conditions (fund operator conditions), (b) all investors in the fund are within the designated categories of investors and primarily are non-Japan residents (investor conditions), (c) the investors investing in the fund are primarily non-resident investors, and (d) an advance notification is submitted (notification requirement) to the local financial bureau (such as the Kanto Local Financial Bureau), as further discussed below. Importantly, the Proposed Bill provides only a framework of requirements in the bill. While these requirements (as they are included in the Proposed Bill) are listed below, far more clarity is needed, and it is intended that this would be provided by the implementing regulations and additional guidance to be issued by the FSA, which the FSA would propose upon the National Diet passing the Proposed Bill and adopt upon considering comments from the public.

Fund Operator Conditions

The Proposed Bill requires a fund operator to satisfy certain conditions, including:

- Human resources adequate to operate exempt activities appropriately;
- An effective internal control system;
- An office in Japan; and
- A representative in Japan (if the fund operator is a foreign corporation.

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Investor Conditions

To rely on the Foreign Investor Fund Exemption, all investors in the fund must satisfy one of the following criteria:

- Foreign corporations or individuals resident in countries outside of Japan that satisfy investor eligibility requirements based on their knowledge, experience, and assets;
- Qualified institutional investors (QII);[9] or
- Parties closely related to the fund operator.

Primarily Non-resident Investor Requirement

In addition, funds invested in the fund would have to come primarily from non-resident investors. The Policy Recommendation indicated that the "primarily" non-resident investor requirement should mean 50 percent or more of investors are nonresident; however, it would be specifically determined by the relevant implementing regulations to be issued by the FSA.

Notification Requirement

A fund operator relying on the Foreign Investor Fund Exemption must notify the relevant Local Finance Bureau in advance, and subsequently, of any changes to the notified matters without delay, i.e., within two weeks.

Other Notable Requirements

A fund operator relying on the Foreign Investor Fund Exemption must keep books and records and submit annual reports. That fund operator would also be subject to certain conduct regulations and investor protection requirements applicable to registered broker-dealers, investment managers, and investment advisers, such as internal operation management requirements, advertising rules, investor notice disclosures prior to investment, prohibition on loss compensation, suitability requirements, separation of client assets, investor reporting requirements, and certain other disclosure requirements. In addition, that fund operator must provide limited public disclosure and be subject to (i) supervision by the relevant Local Finance Bureau; and (ii) applicable Japanese anti-money laundering requirements.

Key Takeaways and Observations

The Foreign Investor Fund Exemption framework presented in the Proposed Bill provides a licensing exemption similar to the exemption provided under the "QII Exemption" or "Special Business Activities for Qualified Institutional Investors" under Article 63 of the FIEA (the Article 63 Exemption),[10] which is a popular exemption for private equity funds, real estate funds, and other types of funds that are structured in a partnership form with limited liquidity, although with certain significant distinctions, as set out below.

First, because the Foreign Investor Fund Exemption is intended to incentivize foreign asset managers to establish offices in Japan, the exemption would specifically require an office in Japan, which was directed by the Policy Recommendation, and for there to be certain human resource and internal control systems in place.

Second, under the Proposed Bill, investor eligibility is more limited than the Article 63 Exemption as it relates to Japan resident investors. The Foreign Investor Fund Exemption allows only Japan resident investors that are QIIs or the fund operator's closely related parties and whose investments would likely be capped at 49.9 percent of the total assets managed by the fund, in addition to investor conditions that investors must satisfy certain criteria

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discussed above. In contrast, the Article 63 Exemption allows unlimited QIIs and up to 49 non-QII investors who satisfy one of the wide range of eligibility requirements that range from a large corporation with a capital of ¥10 billion to officers of a publicly traded company. However, unlike the Article 63 Exemption that requires at least one QII investor at all times, the Foreign Investor Fund Exemption—though not allowing investments by Japan resident investors other than those who are QIIs—requires no QII investor, or Japan resident investors at all, consistent with the policy intent to make things easier for a foreign-based fund operator to enter Japan.

Third, the Foreign Investor Fund Exemption also provides certain eligibility requirements for non-Japan resident investors, whereas under the Article 63 Exemption, non-Japan resident investors are simply ignored for purposes of the Article 63 Exemption.

That being said, the day-to-day viability of the Foreign Investor Fund Exemption largely depends on the level of flexibility the FSA sets out in its implementing regulations. For example, how the FSA establishes the human resource and internal control requirements is likely to have a significant impact on the availability of the exemption. Whether the FSA requires on-site compliance support or would permit overseas compliance support and how high the FSA would raise the investor eligibility bar with respect to non-Japan resident investors are key areas to focus on. Furthermore, in relation to a fund operator who wishes to establish a new office in Japan, the level of specificity that the FSA would require at the time of initial notification would have practical implications, for example, whether the fund operator would be required to enter into a lease agreement before it would be able to submit the required notification or a plan would be permitted.

Interested parties, in particular, foreign asset managers who are interested in opening offices in Japan, should continue to monitor the developments and consider participating in the public comment opportunity when the FSA proposes its implementation regulations, which could happen as early as the summer of 2021.

The Foreign Investor Fund Exemption is not available for funds organized as corporations or trusts. The Policy Recommendation explains that the reasons that the Foreign Investor Fund Exemption is available only for so-called “self-management” of partnership-type collective investment scheme interests, one specific category of investment management business requiring registration under the FIEA, are because:

7. This type of management is considered more flexible than other types of investment management business, such as the investment management business of assets in corporate funds or investment trusts and, as such, a variety of fund management businesses, including venture funds, hedge funds, and real estate funds, could be included in this category; and
8. While the underlying policy consideration is that the fund's clients are primarily foreign investors and there is less need for FSA supervision, if the exemption is made available for more liquid, open-ended funds, such as corporate funds or investment trust funds, the applicable investor requirements could be evaded.

Furthermore, the Foreign Investor Fund Exemption is not available for managed accounts (investment management under a discretionary investment management agreement) either, although the Policy Recommendation specifically noted an opinion from a working group member that further consideration should be given whether the exemption should be extended to the investment management of assets in managed accounts if in the future it is confirmed that there should be a licensing exemption for this category of investment management.

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PROPOSED REGISTRATION MORATORIUM

Yet another form of licensing exemption provided in the Proposed Bill is a licensing moratorium for a period up to five years applicable to foreign investment managers who "engage in investment management business overseas pursuant to laws and regulations of a foreign country" and have no Japanese investors. More specifically, an eligible foreign investment manager would be exempt from registration with respect to engaging in certain exempt investment management activities in an office to be established in Japan if it submits an advance notification with the Japanese regulator.

Eligible Foreign Investment Managers

To rely on the Registration Moratorium, a foreign investment manager would have to satisfy certain eligibility requirements, including:

- Being registered with a foreign regulator with regard to its investment management business;
- Having a certain track record, i.e., by having been in the investment management business at least for a certain period to be designated by the FSA;
- Having adequate human resources;
- Having an effective internal control system; and
- Having an office in Japan.

Exempt Investment Management

Activities Activities that an eligible foreign investment manager would be able to engage in its office in Japan would include:

- Investment management activity for certain "foreign investors" (Moratorium Foreign Investors)[11] under a discretionary investment management agreement;
- Investment management activity for assets invested in a foreign investment trust and solicitation and offering of interests in such a foreign investment trust on condition that the investors be Moratorium Foreign Investors; and
- Investment management activity for assets invested in a foreign partnership-type fund and solicitation and offering of interests in such a foreign partnership-type fund on condition that the investors be Moratorium Foreign Investors.

Consistent with the Policy Recommendation, generally, under the Proposed Bill, a foreign investment manager relying on the Registration Moratorium would not appear to be permitted to manage investments by Japanese investors nor manage investment primarily in shares issued by Japanese companies, at least at their Japan offices,.

Notification Requirement

To take advantage of the Registration Moratorium, the foreign investment manager would be required to submit an advance notification with the Japanese regulator.

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Other Notable Requirements

Similar to the Foreign Investor Fund Exemption, a foreign investment manager relying on the Registration Moratorium would be required to keep books and records and submit annual reports. That foreign investment manager would also be subject to certain conduct regulations and investor protection requirements applicable to registered broker-dealers, investment managers, and investment advisers, such as internal operation management requirements, advertisement rules, investor notice requirements prior to investment, prohibition on loss compensation, suitability requirements, separation of client assets, investor reporting requirements, and certain disclosure requirements, as well as being subject to (i) supervision by the relevant Local Finance Bureau, and (ii) to Japanese anti-money laundering requirements.

The Registration Moratorium may be relied upon by a subsidiary in Japan of a foreign investment manager if the subsidiary engages in investment management activities solely for the parent foreign investment manager.

Key Takeaways and Observations

First, the Registration Moratorium would be available only to registered foreign investment managers, and, as such, foreign investment managers relying on an applicable registration exemption in their home jurisdiction would not be able to rely on the exemption.

Second, it appears that the Registration Moratorium would not permit investment management activities involving Japanese investors. In this regard, the Policy Recommendation appears to suggest this limitation as the basis for not requiring registration; however, it arguably conflicts with the purpose of the Registration Moratorium, which is to provide time and opportunities for foreign investment managers to build track records in Japan without first having to register with the Japanese regulator, as the Policy Recommendation provides. While the implementation regulations to be proposed by the FSA may provide a better picture of how the FSA expects the moratorium be used by foreign investment managers, the Registration Moratorium as provided in the Proposed Bill may not be useful for foreign investment managers who intend to open an office in Japan and expand their Japan businesses through that office.

Lastly, similar to the Foreign Investor Fund Exemption, the practicability of the Registration Moratorium would depend on the level of flexibility the FSA would provide in its implementation regulations with respect to, for example, human resources and internal control requirements.

Under the Proposed Bill, the Registration Moratorium itself would expire five years from the effective date of the amendments, and, as such, the period of moratorium could effectively be shorter than five years.

Unlike the Foreign Investment Fund Exemption, the Registration Moratorium is available for funds organized as corporations or trusts. It is also available for managed accounts (investment management under a discretionary investment management agreement).

NEXT STEPS

As noted above, the Proposed Bill is expected to pass the National Diet during the current session. Upon promulgation of the legislation, the FSA will propose amendments to its ordinances and regulations and take comments from the public. While the Proposed Bill provides the framework for these regulatory forms of licensing exemptions, a lot is delegated to the FSA's implementing regulations, which ultimately determine the practicability

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of the proposed regulatory relief. The Policy Recommendation provides a bold agenda to attract foreign asset managers to Japan in a post-pandemic world. Interested parties should monitor the developments closely and consider engaging with the regulator and prepare to participate in the anticipated public comment opportunity to shape how this relief will be implemented.

The overriding goal of "Japan as a global financial center" is to create an attractive business and living environment for foreign nationals who are intending to conduct asset management businesses in Japan, so that "foreign nationals may consider Japan as an anxiety-free 'choice location' for conducting business as part of potential market entrants' global business schemes."[12]

"Anxiety-free" is certainly compelling. Let us see how it plays out. Please contact the authors if you have any questions.

FOOTNOTES

[1] *E.g., see* Ryozo Himino, Commissioner of the FSA, *Preparing for a strong post-COVID growth* (Oct. 12, 2020).

[2] *See* Cabinet Office, *New Economic Measures* (Dec. 8, 2020).

[3] On 31 March 2021, the Japanese National Diet (the National Diet) passed legislation allowing certain asset managers to treat performance-based salaries as deductible expenses under certain conditions for corporate tax purposes and exempting overseas assets of certain non-Japanese individuals from Japanese inheritance tax. The legislation was promulgated and became effective as of 1 April.

[4] Please refer to the summary chart prepared by the FSA, available here, which also provides contact information.

[5] *See* FSA,*Japan as an International Financial Center* (Mar. 11, 2021).

[6] FSA, The Working Group on Capital Market Regulations of the Financial System Council, *First Report – Regulatory Policy: Toward an International Financial Hub* (Dec. 23, 2020).

[7] Identified as "Specially Permitted Business for Foreign Investors, etc." in Proposed Article 63-8 of the FIEA. We note that the Registration Moratorium is only available for foreign managers operating in countries or jurisdictions that regulate investment management business at the same standards as those of Japan in light of ensuring investor protection, which is to be designated by the relevant Cabinet ordinance.

[8] Identified as "Specially Permitted Business During Transition Period" in Article 3-2 of the Supplementary Provision to the Proposed Bill.

[9] Qualified Institutional Investors are certain investors specified by a Cabinet Office order as those having expert knowledge of and experience with investment in securities. Article 2(3)(i).

[10] For additional information about the Article 63 Exemption, please see our previous articles, including this alert.

[11] In the Proposed Bill, Moratorium Foreign Investors are defined as foreign corporations, individuals who are residents of a foreign country, closely related parties of the foreign investment manager, and other investors deemed the equivalent of the foregoing under the FSA's implementation regulations.

[12] *See* Cabinet Office, *New Economic Measures* (Dec. 8, 2020).

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