The Asset Management Review

Fourth Edition

Editor
Paul Dickson

Law Business Research

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For further information please email
Nick.Barette@lbresearch.com

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Fourth Edition

Editor
Paul Dickson

Law Business Research Ltd

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

SENIOR ACCOUNT MANAGERS
Katherine Jablonowska, Thomas Lee, Felicity Bown, Joel Woods

ACCOUNT MANAGER
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EDITORIAL ASSISTANT
Sophie Arkell

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Anne Borthwick

SUBEDITOR
Charlotte Stretch

MANAGING DIRECTOR
Richard Davey

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EDITOR'S PREFACE

Following several challenging years in the wake of the global financial crisis of 2007–2008, recent years have seen a more sustained economic recovery take hold. However, despite significant improvements in the global economic landscape, 2014 was marked by significant geopolitical events, which have taken their toll on financial markets outside the US and Japan. In the UK, both the Scottish referendum and predictions of a close general election outcome in May 2015 created an uncertain political environment. At a European level, markets have been faced with continuing tensions in Eastern Europe, as well as the ongoing sovereign debt issues, with the Greek crisis featuring heavily in news headlines over the past 12 months. The collapse of oil prices, the spread of the Ebola virus in West Africa and the ongoing conflict in the Middle East have also had a significant impact on the global economy.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. By way of example in the UK, changes to the rules governing what retirees can do with their pension benefits look set to open up a new section of the market to discretionary managers and product providers.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, major changes to the regulatory landscape were introduced by the Alternative Investment Fund Managers Directive, which has applied in full since July 2014, and this trend is set to continue in other areas of the asset management industry with the implementation of changes to the UCITS regime and the revised Markets in Financial Instruments package. In the UK, the Financial Conduct Authority has announced plans for a market study on the asset management industry and the charges it levies on investors.

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis; the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Investors and regulators' demands for greater clarity on fees and commissions charged by fund managers for services provided also remain a constant presence.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements and adapt to the changing geopolitical landscape. Despite the challenges outlined above, confidence has begun to return across a number of areas, buoyed by increasingly positive assessments of the global economic outlook, which raises the prospect of increased investment and returns. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the fourth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank Gideon Roberton and his team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that the fourth edition of *The Asset Management Review* will a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
September 2015

Chapter 18

JAPAN

Yasuzo Takeno and Fumiharu Hiromoto[1]

I OVERVIEW OF RECENT ACTIVITY

'From savings to investments' has been a government slogan since the late 1990s, expressing its policy to increase Japanese household investment in financial assets. Historically, this policy has had limited success. However, Japanese household assets represent a reported ¥1,600 trillion, and encouraging the investment of those assets in growing businesses is one of the most important policies of the 'third arrow' of the Abe government's growth strategy. Investment funds in particular are considered to be an important measure of the success of this investment drive by the Financial Services Agency of Japan (FSA).[2]

Thanks to the remarkable performance of Japanese listed companies under relaxed monetary policy and a depreciated yen, the Nikkei average has more than doubled since the Abe government came into power and investments made by Japanese households have witnessed impressive gains in the equity markets. The total assets held by Japanese domestic investment funds for public offer reached a historical high of ¥100 trillion in May 2015 (a 68 per cent increase during the two-and-half years under the Abe government), and the profit accrued by Japanese domestic funds in 2014 reached ¥6.5 trillion, the highest in the past five years.

On the other hand, it has been reported that there remain some problems regarding disclosures concerning investment funds made by investment trust companies, investment management companies and distributors of investment funds. A typical issue is that of disclosure within prospectuses and performance reports of monthly distribution type funds. These funds aim to make a monthly distribution even if the fund has no

1 Yasuzo Takeno is a partner and Fumiharu Hiromoto is of counsel at Mori Hamada & Matsumoto.

2 'Japan Revitalisation Strategy' (Revised 2014) (Cabinet Decision of 24 June 2014).

distributable income or capital gains, and the distribution may come from the fund's capital. Concerns have been raised that sufficient information or explanation of this distribution mechanism is not always provided to investors. This is particularly the case for elderly investors, who consider these funds to be a safe alternative to their pension funds.[3] More fundamentally, it is also pointed out that 'in the business of offering financial products/services, there is a gap in the volume of information between the supplier (i.e., financial institutions) and the end-user (i.e., customers). As such, financial institutions may operate their businesses focusing on short-term profits and business expansion, instead of in the interests of their customers.'[4]

To overcome these issues, the government has emphasised reform to the fund management business by increasing the transparency of investment fund management.[5] In this context, a new performance report system came into effect on 1 December 2014 following an amendment to the Investment Trust and Investment Corporation Act (ITICA), under which a fund's management company is now able to provide fund performance reports containing matters material to investors via their website. Under the new performance report system, the FSA, the Investment Trust Association of Japan (ITAJ, a self-regulatory organisation whose members are Japanese investment trust companies) and the Japan Securities Dealers Association (JSDA, a self-regulatory organisation of Japanese financial products operators) all require performance reports to carry enhanced contents, including information relating to the source of distributions and total returns, to enable investors to recognise the true performance of the fund even in cases where a monthly distribution is made out of the fund's capital amount.

Further, under its Financial Monitoring Policy for 2014–2015, the FSA requires financial institutions (including asset management businesses) to provide an 'effective response to the needs of customers'. Under this policy, 'the FSA will review whether financial institutions, under their customer-oriented policy, are providing financial products/services that are really beneficial for their customers' (i.e., is there any abuse of a dominant position, or are there any conflicts of interests between institutions and customers; and is there any mis-selling of financial products or services due to inappropriate incentives regarding commissions and business relations?).

As one example of customer-oriented policy, Japanese regulations regarding both Japanese investment trusts and foreign domiciled investment trusts that are publicly offered in Japan were amended as of 1 December 2014 and require, *inter alia*, the manager or investment manager of a fund to manage risks relating to derivatives transactions in accordance with rules adopted in advance by the manager or the investment manager. The new regulations also introduced credit risk management regulations, which came into effect on the same day. However, in respect of foreign domiciled investment trusts, the credit risk management regulations have a grandfather period of five years, during

3 Minutes of the second meeting of the Financial System Council's working group on a revised system of investment trust and investment corporation, 6 April 2012.

4 FSA, Financial Monitoring Policy for 2014–2015 (Policy for Supervision and Inspection), September 2014.

5 Japan Revitalisation Strategy (Revised 2014) (Cabinet Decision of 24 June 2014).

which time the new regulations do not apply to foreign funds that were publicly offered in Japan prior to 1 December 2014 (see Section II.v, *infra*).

Article 63 of the Financial Instruments and Exchange Act of Japan (FIEA) regarding the qualified institutional investors exemption (see Section II.iv, *infra*) was also amended on 27 May 2015. The amendment followed a report of the Financial System Council's working group (WG) dated 28 January 2015, which released a revised system for funds targeting professional investors. Under Article 63 of FIEA, a person or legal entity operating a business that qualifies for the qualified institutional investors exemption (a 'QII-targeted fund operator') need only file a notification with the local financial bureau in order for it to be exempted from the registration requirement for conducting an investment management business. Previously, FIEA imposed on QII-targeted fund operators only a few of the restrictions and impositions on conduct of business normally applied to investment managers. There were, however, several scandals that saw unsophisticated investors suffer losses after having invested in funds utilising the qualified institutional investors exemption. In May 2014, the FSA released proposed drafts (2014 Proposed Drafts) of amendments to FIEA to the public for comment. The 2014 Proposed Drafts limited the scope of investors permitted to invest in funds invoking the qualified institutional investors exemption. Although such amendments were scheduled to take effect on 1 August 2014, the FSA received a number of public comments against the 2014 Proposed Drafts from independent venture capital and other business players, and decided to put the 2014 Proposed Drafts on hold. In October 2014, the WG conducted a comprehensive review of the QII-targeted fund exemption and, based on its report, an amendment to Article 63 of FIEA was introduced, making QII-targeted fund operators subject to, *inter alia*, the following:

a a fiduciary duty and a duty of care of a good manager;
b a prohibition against making a transaction that would harm investors' interests;
c compliance with principles of suitability;
d a requirement for the delivery of a performance report; and
e a requirement for documents to be delivered prior to or upon execution of contracts.

The last three items will not apply to QII-targeted fund operators that receive investments from sophisticated investors only. The QII-targeted fund operator must also prepare and deliver to the relevant authority a business report, and prepare and maintain certain books and records.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i General

Japanese regulations on asset management vary depending on whether an asset manager has been delegated discretionary authority to manage a client's assets on the client's behalf, or whether the asset manager is simply able to provide investment advice. The provision of asset management services in Japan requires registration with the FSA, regardless of whether an asset manager has discretion to manage a client's assets on the client's behalf.

Activities of the general partner of a foreign limited partnership are regulated as asset management business and in principle require registration under FIEA for solicitation of investment in Japan (self-solicitation) and management of the assets of the limited partnership (self-management) following the enactment of FIEA, which replaced the Securities And Exchange Act of Japan in 2007. Certain exemptions and exceptions are available to this registration requirement. For example, self-solicitation activities will not require registration if the general partner appoints a registered securities broker as a distributor in Japan and does not itself engage in any solicitation. Self-management activities will be exempt from registration if the interests in the limited partnership are acquired by one or more qualified institutional investors (QIIs) and the number of the non-QII investors is limited.

Regulations applying to the sale of a foreign investment trust in Japan depend on whether the sale is by public offering or private placement. A public offering requires filing of a securities registration statement, which is filed and disclosed to the public via the internet, as well as an FSA statement, which is for administrative purposes and is not disclosed to the public. Public offerings of foreign investment trusts must comply with certain investment restrictions, which are intended to prevent excessively risky products prohibited from Japanese investment trusts from being offered to the Japanese public. Such investment restrictions do not apply to foreign investment trusts sold by way of private placement.

ii Regulations applying to non-discretionary investment advisers and discretionary investment managers

Japanese regulation classifies investment managers into two categories: non-discretionary advisers and discretionary investment managers.

Non-discretionary advisory business

Non-discretionary advisory business is business providing advice on the value of securities or investment decisions based on the value of financial instruments in return for fees.

Providing advice on the value of securities or investment decisions based on the value of financial instruments through newspapers, magazines or books available to the public will not fall under the scope of non-discretionary advisory business. However, the provision of advice through a website requiring readers to register as members to pay fees where that advice is not otherwise publicly available will likely fall under the scope of non-discretionary advisory business.

Discretionary investment management business

Four subcategories of discretionary investment management business

Investment management business is divided into the following four subcategories:

a investment management business managing assets of an investment corporation established under ITICA by investing in securities or derivatives under an asset management contract with an investment corporation (investment corporation asset management services);

b investment management business managing assets of an investor by investing in securities or derivatives under a discretionary investment management contract (discretionary investment management services);

c investment management business managing assets of an investment trust under ITICA (including foreign investment trusts) by investing in securities or derivatives, and acting as a settlor of such investment trust (investment trust management services); and

d investment management business managing assets of a collective investment scheme, which is generally a partnership (not including corporate type collective investment schemes) such as a partnership under the Civil Code of Japan, a silent partnership under the Commercial Code of Japan, an investment business limited partnership under the Investment Business Limited Partnership Act of Japan, a limited liability partnership under the Limited Liability Partnership Act of Japan, or any similar foreign entity, as a general partner of such collective investment scheme by investing predominantly in securities or derivatives (collective investment scheme management services).

With regards to items (a) and (b), if the managed assets include real property, the investment manager will need to have a real property transaction licence under the Land And Building Transaction Act of Japan (LBTA). If the assets managed are predominantly invested in real property, the investment manager is required to have transaction discretionary representation approval under the LBTA. In addition, the management of the assets of an investment corporation (item (a)) or an investment trust (item (c)) by investing in real property falls under the definition of Specified Investment Management Activities and requires approval from the FSA under ITICA. Almost all listed Japan real estate investment trusts (J-REITs) are classified under item a (investment corporation) rather than item (c) (investment trust).

With respect to item (b) above, if the managed assets are invested in the beneficiary interests of a trust whose underlying assets are real property, such management is referred to as real property-related specified investment management and requires registration as a general real property investment adviser under the Real Property Investment Advisory Rules governed by the Ministry of Land, Infrastructure, Transport and Tourism of Japan (MLIT) as a prerequisite to the registration of the discretionary investment management services.

In a wrap account or separately managed account (an SMA), assets deposited in the SMA are managed by investing in shares, bonds or other financial instruments in accordance with the investment policy agreed from the outset. As the operators of SMAs are delegated the trading authority to manage the account by investing in securities, their services are classified as discretionary investment management, and the operator must be registered to provide discretionary investment management services.

Exceptions

A non-discretionary investment adviser or discretionary investment manager located and licensed in a foreign jurisdiction may provide, respectively, non-discretionary investment advice or discretionary investment management services to a registered Japanese discretionary investment manager without requiring registration under FIEA.

Investment trust management services include management of a foreign investment trust. This is intended to capture the situation where a Japanese investment manager directly manages a foreign investment trust within the scope of the investment

trust management services. However, if a person conducting investment management business outside of Japan pursuant to a foreign law manages a foreign investment trust, this activity will not fall under the scope of investment trust management services and so will not require registration under FIEA.

iii Registration of discretionary management business and non-discretionary advisory business

Registration of non-discretionary advisory business

Registration is normally required under FIEA for any person wishing to operate a non-discretionary advisory business in relation to securities or derivatives (an 'investment advisory business'). Any individual or corporation may register to perform investment advisory business once it has met the various requirements for qualification. These include the satisfaction of certain registration requirements, for example, having in place compliance systems appropriate for an investment advisory business. Successful registration also requires the deposit of ¥5 million with the governmental deposit office. Registration further requires an investment advisor to comply with certain conduct rules, including (for example) a restriction on providing advice to customers that is designed to encourage entry into transactions that would harm their interests while promoting another customer's interests.

Successful registration of an investment advisory business also gives rise to a number of administrative obligations, such as the preparation of business reports for each business year, and submission of those reports to the FSA. The investment adviser will also be required to prepare and maintain books and documents in relation to the investment advisory business.

Registration of discretionary management business

To be registered as a discretionary investment manager, a person must meet a number of requirements, including the entity requirement. Under this restriction, only a joint-stock corporation incorporated under the Corporation Act of Japan and having a board of directors and a corporate auditor or a committee, or a foreign company that is similarly organised and has a business office in Japan, is eligible to register as a discretionary investment manager. The prospective discretionary manager must also meet the minimum capital amount and net worth requirements (in each case, ¥50 million or more), and certain compliance system requirements, such as a personnel structure appropriate to engage in discretionary investment management.

In contrast to the requirements of an investment advisory business, the requirements for registration as a discretionary investment manager are significantly more onerous. Like a non-discretionary investment manager, a registered discretionary investment manager is subject to certain codes of conduct, and is, for example, restricted from implementing investments that lead to transactions with itself, or to transactions involving any other assets managed by it. It is also required to prepare and maintain books and documents in relation to its investment management business, and prepare yearly business reports for submission to the FSA. A registered discretionary investment manager providing investment corporation asset management services or investment trust management services is also subject to certain additional obligations under ITICA,

such as a duty to procure a third-party appraiser to investigate the asset value when investing in real property.

A registered discretionary investment manager is in principle prohibited from engaging in any businesses other than financial instruments transactions, in order to insulate the discretionary investment management business from risks unrelated to financial instruments transactions. That said, a registered discretionary investment manager is permitted to engage in certain businesses that are ancillary to financial instruments transactions, such as M&A advisory and business consulting. On making further filings with the regulator, a registered discretionary investment manager will be permitted to engage in certain other businesses, such as commodities-related business, money lending and real property brokerage.

iv Fund regulations

Self-solicitation

Solicitation by an issuer of certain securities, including units of a Japanese or foreign investment trust, or interests in a Japanese or foreign collective investment scheme, such as Japanese silent partnerships or foreign limited partnerships, are regulated as self-solicitation under FIEA.

An issuer of a Japanese or foreign investment trust or collective investment scheme who solicits its own securities is in principle required to be registered as a Type II financial instruments transaction business. However, if it retains a distributor of the securities it issues, and does not make any solicitation itself, no registration will be required.

The issuer of a Japanese investment trust is the trust settlor, and in that capacity it will also act as the trust manager. How the issuer of a foreign investment trust will be classified will depend on the applicable governing law and documents. If a foreign investment trust is established by a bilateral trust deed between the manager and the trustee, and the governing law or document provides that units of the trust are issued by the manager, the manager will be the issuer of the investment trust. As a result, this will amount to self-solicitation, and the issuer will need to be registered on that basis in order to offer its own securities in Japan. If a foreign trust is established by a unilateral declaration of trust by the trustee, the trustee will be the issuer. To avoid the registration requirement of self-solicitation, the issuer (who is the manager or the trustee, as the case may be) must have a Japanese distributor, and not engage in any solicitation itself.

In collective investment schemes, the managing partner or general partner of a Japanese or foreign limited partnership, or the business operator of a Japanese silent partnership, will be the issuer of the securities.

Self-management

Management of assets by operators of certain funds, including Japanese or foreign collective investment schemes, is regulated as self-management under FIEA, and requires registration to offer collective investment scheme management services if the fund invests more than 50 per cent of its assets in securities or derivatives. Typical examples of such collective investment schemes are Japanese or foreign limited partnerships and Japanese silent partnerships.

Prior to the enactment of FIEA, which replaced the Securities and Exchange Act of Japan in 2007, management of assets by such fund operators was regarded as management of the operator's own assets, and was outside the scope of the regulation. However, the FIEA regulations now recognise this as management of investors' assets, having been extended to catch such management activities by fund operators.

Qualified institutional investors exemption

The registration requirements for carrying out Type II financial instruments transaction business (in cases of self-solicitation) and discretionary investment management (in cases of self-management) are waived if the qualified institutional investors exemption under FIEA is available.

The qualified institutional investors exemption is available if the investors of a collective investment scheme together consist of at least one or more QIIs and up to 49 non-qualified institutional investors. Where the qualified institutional investors exemption is used to avoid registration as a Type II financial instruments transaction business, additional transfer restrictions apply so that the QIIs are prohibited from selling their interests in the collective investment scheme to non-qualified institutional investors, and are prohibited from selling their interests other than by selling their interests as a whole.

In order to take advantage of the qualified institutional investors exemption, a filing with the regulator needs to be made in advance. In the case of self-solicitation, the issuer of the collective investment scheme will make this filing, while in the case of self-management, the manager of the collective investment scheme will make the filing. The issuer or the manager (as the case may be) will normally be the general partner in the case of a limited partnership, or the business operator in the case of a Japanese silent partnership. The filing document is relatively simple and can be prepared in English.

QIIs include banks, insurance companies, securities companies and other operators carrying out financial instruments transaction business. Business corporations can be recognised as QIIs if they have securities investments greater than ¥1 billion and make an additional filing with the FSA.

Exception to self-management by delegation of all management authority

If a general partner or similar entity of a collective investment scheme delegates its entire investment authority to a discretionary investment manager, the management activity of that general partner or similar entity will be excluded from the scope of collective investment scheme management services, and registration as a discretionary investment manager will not be required.

Exception to self-management for foreign collective investment schemes

If investments from Japan to a foreign collective investment scheme are limited, the management activity of the general partner or the similar entity of the foreign collective investment scheme is excluded from the scope of the collective investment scheme management services (limited Japan relationship exception). Specifically, the following requirements must be met:

a Japanese investors directly or indirectly investing in the foreign collective investment scheme are QIIs only;

b the number of such Japanese investors is less than 10; and

c the total contributions from such Japanese investors are less than one-third of the total contributions of all investors in the collective investment scheme.

v Sale of a foreign investment trust in Japan

Public offering of a foreign investment trust in Japan

JSDA requirements

For a foreign investment trust to be publicly offered in Japan, the foreign investment trust needs to satisfy certain requirements set out by JSDA, a self-regulatory body of securities companies acting as distributors in the context of foreign investment trusts. A member of JSDA cannot engage in a public offering of a foreign investment trust that does not satisfy the JSDA requirements. Most of the JSDA requirements do not apply to a private placement of a foreign investment fund, and thus members of JSDA may engage in such private placements.

The JSDA requirements for the public offering of a foreign investment trust include:

a the net asset value of the fund is, or is expected to be after the public offering in Japan, greater than ¥100 million;

b the net asset value of the management company of the fund, which is the issuer of units of the fund, is greater than ¥50 million. The JSDA requirements appear to assume that a foreign investment trust publicly offered in Japan will be established by a bilateral trust agreement between a management company and a trustee. As a result, most foreign investment trusts publicly offered in Japan are established by bilateral trust deeds, as opposed to a unilateral declaration of trust;

c the Japanese courts have jurisdiction over lawsuits relating to transactions through which a Japanese investor has acquired units in the trust;

d an agent company of the fund is appointed in Japan: a distributor of the fund in Japan (i.e., a Japanese securities company) is usually appointed as the agent company. The agent company is required to confirm whether the JSDA requirements have been satisfied before making the public offering, and will disclose the net asset values of the fund to the public following the public offering;

e the amount of securities sold short does not exceed the net asset value of the fund;

f borrowing by the fund is generally less than 10 per cent of the net asset value of the fund;

g voting rights in any company held by the fund and other funds managed by the management company do not exceed 50 per cent of the total voting rights of that company;

h the exposure to derivative transactions is to be calculated in accordance with a reasonable method set in advance by the management company or the investment manager, and does not exceed the net asset value of the fund. This requirement was introduced in 1 December 2014 with no grandfather arrangement; and

i credit concentration risks borne by the fund are managed in accordance with a reasonable method set in advance by the management company or the investment manager. This requirement was introduced on 1 December 2014. A grandfather arrangement exists whereby the requirement does not apply for a period of five years to existing funds publicly offered in Japan prior to 1 December 2014.

When a foreign investment trust is a master-feeder fund and the feeder fund is publicly offered in Japan, the question arises as to whether the JSDA requirements will be applicable only to the feeder fund or also to the master fund – in other words, whether the master fund is looked through. Currently, general practice is to apply the JSDA requirements to the feeder fund only, and not to look through the master fund. The exception to this is the credit concentration restriction, which cannot be complied with unless the master fund is looked through due to all of the feeder fund's assets being invested or concentrated in the master fund.

Disclosure – securities registration statement and prospectus

The issuer of a foreign investment trust (i.e., the management company of the fund) must file a securities registration statement with the regulator in advance via EDINET, a web-based disclosure system managed by the FSA. The securities registration statement is a disclosure document under FIEA of securities that are publicly offered in Japan and is disclosed to the public through the internet. Once filed, the securities registration statement becomes effective after 15 clear days. Solicitation of investment into the securities can be made before the securities registration statement becomes effective, but execution of the investment cannot be made until the securities registration statement becomes effective and a mandatory prospectus is delivered to the investor.

The prospectus of an investment trust consists of a mandatory prospectus and a prospectus upon request. The contents of the prospectus upon request are substantially similar to those of the securities registration statement with minor adjustments and omissions. The mandatory prospectus is a summary of the prospectus upon request. The mandatory prospectus needs to be delivered to investors on or prior to execution of the purchase of the securities. The prospectus upon request is delivered to investors only where specifically requested by investors.

FSA filing

Pursuant to ITICA, the issuer of a foreign investment trust that is publicly offered in Japan must file an FSA statement with the FSA immediately before the securities registration statement becomes effective. Most of the contents of the FSA statement overlap with those of the securities registration statement and as a result, the FSA statement is usually prepared by recycling the necessary information from the securities registration statement. The FSA statement is for administrative purposes only, and is not disclosed to the public.

Private placement of a foreign investment trust in Japan

Private placement of securities in Japan is classified into two categories (minor variations aside): private placement to QIIs only and private placement to small numbers of investors.

In a private placement for QIIs only, investors are limited to QIIs. There is no limit to the number of QIIs who may invest in a private placement. The QIIs are, however, prohibited from selling on their securities to non-QIIs.

In a private placement for a small number of investors, the number of investors in a private placement is limited to 49. The investors are prohibited from selling their securities unless transferring them to a single investor as a whole. This restriction ensures that the cap on the total number of investors is not breached.

Neither a securities registration statement nor a prospectus is required if a foreign investment trust is offered in Japan by way of private placement.

However, an FSA statement needs to be filed even for the purposes of a private placement before any solicitation of investment is made in Japan. While an FSA statement in a public offering is filed after the securities registration statement is filed (i.e., where solicitation has begun but before the securities registration statement becomes effective), the FSA statement in a private placement must be filed prior to any solicitation in Japan.

A solicitation made in Japan by the issuer of a foreign investment trust (in the case of a bilateral trust deed type unit trust, the manager, or in the case of a unilateral declaration of trust type unit trust, the trustee) is regarded as self-solicitation under FIEA and requires registration as a Type II financial instruments transaction business (see Section II.iv, *supra*). If a distributor is appointed in Japan (usually a securities company) and the issuer of the foreign investment trust does not engage in any solicitation, this registration requirement is not triggered.

Investment from Japan to a foreign investment trust without any solicitation in Japan

It may be that a Japanese investor, usually a sophisticated institutional investor, approaches a foreign investment trust without any solicitation made in Japan by the foreign investment trust and makes an investment in the foreign investment trust. In such cases, an FSA statement of the foreign investment trust is not required on the basis that there has been no solicitation in Japan.

It is a matter of fact as to whether there has been any solicitation in Japan; however, it should be stressed that if a foreign investment trust has any involvement in Japan through a subsidiary, or an affiliate or representative office, there may be a risk that the activities of such entities are regarded as soliciting investment in the foreign investment trust.

III COMMON ASSET MANAGEMENT STRUCTURES

i Investment trusts and investment corporations

For retail or institutional investors seeking a diversified portfolio investment in shares and bonds, Japanese and foreign investment trusts are commonly used. For retail investors, investment trusts are sold through public offerings.

ITAJ is a self-regulatory body of Japanese investment managers engaging in the management of investment trusts, and sets out certain requirements that publicly offered Japanese investment trusts must satisfy. The ITAJ requirements are quite similar to the JSDA requirements that foreign investment trusts that are publicly offered in Japan must satisfy. Publicly offered Japanese investment trusts and publicly offered foreign investment trusts are intended to stand on equal footing through the ITAJ requirements and the JSDA requirements.

There are two ways to bring a foreign investment trust to Japan for public offering. One is to directly make a public offering of the foreign investment trust. The other is to set up a Japanese investment trust that will invest in the foreign investment trust. There are certain complications with the latter approach. A publicly offered Japanese investment trust is generally restricted from investing in a foreign fund of funds under

the ITAJ rules. As such, if the foreign investment fund to be brought into Japan is a fund of funds, it will not be possible to use a Japanese investment trust as a feeder fund. In addition, a Japanese investment trust acting as a fund of funds is generally required to make investments into multiple funds. When a foreign investment trust is brought into Japan through a Japanese investment trust as feeder fund, the feeder fund therefore invests a small portion of the fund's assets into a money management fund to satisfy this diversification requirement. This investment aside, the remainder of the feeder fund's assets will be invested in the foreign investment trust.

For institutional investors pursuing a diversified portfolio investment in shares and bonds, Japanese or foreign investment trusts are usually sold through private placements. A private placement of a foreign investment trust will still require an FSA statement to be filed in advance (see Section II.v, *supra*).

For retail or institutional investors who wish to have a portfolio investment in real property, J-REITs are commonly used. Shares in many J-REITs are listed on Japanese securities exchanges. The number of privately placed J-REITs whose shares are not listed has recently been increasing. For regulatory issues relevant to J-REIT investment managers, see Section II.v, *supra*.

ii Collective investment schemes – limited partnerships, TK-GK

For PE investments, limited partnerships in Japan and in foreign jurisdictions such as the Cayman Islands or Delaware are commonly used.

For institutional investors who want to invest into relatively limited real properties, a TK-GK scheme on a private placement basis is common. The term TK-GK refers to a silent partnership under the Commercial Code of Japan, where an investor makes a financial contribution to an operator and the operator conducts business under its own name. The identity of the TK investor is not disclosed to third parties who engage in transactions with the TK operator. A TK (*tokumei kumiai*) is a pass-through entity, where the TK itself is not a taxable entity in respect of profits generated from the TK business, and profits and losses are allocated to the TK investor and taxed at the TK investor level. A GK (*godo kaisha*) is a corporation under the Corporation Act of Japan, which is similar to a limited liability company in foreign jurisdictions in that it exhibits some of the features of both a partnership and a corporation. However, unlike a limited liability company in other jurisdictions, a GK is not a pass-through entity. When investing in real property, a TK-GK cannot directly invest or hold real property for regulatory reasons. Accordingly, a TK-GK will invest in trust beneficiary interests, the underlying assets of which are real property. Trust beneficiary interests are securities under Japanese law; thus, a TK-GK investing in real property trust beneficiary interests is subject to regulation under FIEA.

Foreign or Japanese limited partnerships and TK-GK are collective investment schemes under FIEA. See Section II.iv, *supra*, for the regulatory issues affecting collective investment schemes under FIEA.

iii TMK

TMKs are also common as investment vehicles for institutional investors who are seeking a limited and tailored portfolio of loans and real property. A TMK is a specified purpose

company, and is used for securitisation of assets, including loans and real property. TMKs are pay-through entities where, if more than 90 per cent of the profits are distributed to the TMK's investors (i.e., preferred shareholders), such amount is deducted as an expense from its corporate income. A TMK is able to directly hold real property, as well as real property trust beneficiary interests.

IV MAIN SOURCES OF INVESTMENT

Japanese pension funds remain the dominant investors in the Japanese asset management market, despite the notorious 2012 AIJ scandal (see Section VI.ii, *infra*). According to surveys by the Japan Investment Advisers Association, the total amount of Japanese pension fund assets under discretionary investment management by Japanese investment managers as of March 2015 was approximately ¥116 trillion, an increase of approximately ¥12 trillion from the previous year. In comparison, the total amount of assets under discretionary investment management by Japanese investment managers as of March 2015 was approximately ¥199 trillion. Foreign investors, including foreign institutional investors and offshore funds, are also important investors for Japanese investment managers, with total foreign investor assets under management amounting to over ¥32 trillion as of March 2015.

V KEY TRENDS

In terms of the scale of assets held by residents of Japan under investment trusts, investment management agreements and investment advisory agreements, the total amount of assets decreased in the wake of the global financial crisis, and did not rise again until the Abe government came into power. During the two years following the Great East Japan Earthquake in 2011, the total amount of assets under management decreased further. When Abenomics began in 2013, the total assets under management increased. According to the Japan Investment Advisers Association, as of the end of March of each year, amounts under management were as follows:

Year	*Amounts under management (¥ billion)*
2007	134,379
2008	127,305
2009	127,359
2010	135,848
2011	124,011
2012	124,289
2013	152,104
2014	168,832
2015	189,043

One of the most important purposes of the financial monitoring policy of the FSA is to further accelerate investment flows out of bank savings. The FSA emphasises the

importance of appropriate management of the massive amount of funds and assets invested by households, pension funds and institutional investors in line with the characteristics of each fund and asset and the needs of asset owners. The FSA also emphasises the importance of individual financial institutions fulfilling their roles and responsibilities in all functions involved in asset management, including product origination, financial product sales, portfolio management and asset management itself. Financial institutions' efforts to improve their asset management capabilities will create a virtuous cycle, facilitating steady asset formation for Japanese citizens, accelerating investment flows further, and contributing to the medium to long-term growth of asset managers and relevant markets. Financial monitoring by the FSA is expected to be carried out with these objectives in mind.[6]

VI SECTORAL REGULATION

i Insurance

Variable insurance operates similarly to an investment trust. In variable insurance, the insurance premiums are managed by investment in shares, bonds and other assets, and the insurance proceeds and termination repayments depend upon the performance of the investments. While the costs associated with variable insurance are relatively higher than those of regular investment trusts, variable insurance remains a key investment alternative due to certain advantages they provide. For example, the insurance premiums of variable insurance are tax deductible (subject to certain limitations). As variable insurance does not provide for distributions to investors during the investment period, tax that would be imposed on the distributions of an investment trust is deferred until the payment of insurance money or termination of the insurance. If an heir is designated as payee of the insurance money, the heir is able to enjoy an estate tax exemption of up to ¥5 million per heir.

In light of their similarity to investment trusts, certain regulations dealing with the marketing of investment trusts under FIEA apply *mutatis mutandis* to the marketing of variable insurance. Among other requirements, an explanatory paper must be delivered to a purchaser of variable insurance on or prior to execution of the contract. Items to be described in this explanatory paper are similar to those required by a prospectus prepared in respect of an investment trust.

ii Pensions

Assets of Japanese pension funds are managed by (1) trust banks, (2) insurance companies, (3) discretionary investment managers, or (4) the pension fund itself. The final scenario, in which the pension fund manages the pension fund itself, is called in-house management and is permitted only for pension funds equipped with sufficient human resources. When the assets of a Japanese pension fund are managed by a discretionary investment manager under (3), the pension fund must also enter into a trust agreement with a trust

6 FSA Financial Monitoring Policy for 2014–2015 (Policy for Supervision and Inspection) September 2014.

bank. The management authority of the trust asset is then delegated to the discretionary investment manager, as discretionary investment managers are prohibited from being entrusted with the managed assets.

In the *AIJ* case that came to light in 2012, discretionary investment manager AIJ Investment Advisory Co, Ltd entered into discretionary investment management agreements with a number of pension funds, investing those assets heavily into a Cayman unit trust managed by its affiliate. The assets of the pension funds were entrusted with Japanese trust banks, which held units of the Cayman unit trust. The discretionary investment manager and its affiliated manager of the Cayman unit trust manipulated the net asset values (NAVs) of the Cayman unit trust for a long period of time. The total loss of the pension funds reportedly amounted to approximately ¥200 billion. The registered unitholder of the Cayman unit trust was a securities company acting as the distributor of the unit trust in Japan, which was reportedly also affiliated with the discretionary investment manager and failed to forward the correct information received from the trustee or administrator of the Cayman unit trust to the trust banks and the pension funds.

Following the revelation of the *AIJ* case, regulation surrounding asset management of pension funds has been tightened. Among other measures, trust banks acting as trustees of a pension fund's assets are now required to take measures to ensure they are able to directly access NAVs and the audited reports of funds they act as trustees to. Pension funds are also required to set out rules regarding investment diversification, which is encouraged in order to avoid concentration in a limited number of products.

iii Real property

For retail and institutional investors who wish to have a large and diversified real property portfolio, real estate investment corporations, or J-REITs, are commonly used. J-REIT investment managers must have a real property transaction licence and an approval of transaction discretionary representation under the LBTA, and be registered for discretionary investment management (see Section II.ii, *supra*).

Investment managers to TK-GK structures, which are preferred by institutional investors looking for relatively limited and tailored real property portfolios, are required to hold a real property transaction licence under the LBTA, a registration as a general real property investment adviser under the Rules for Registration of Real Properties Advisory Businesses (which are not laws or regulations, but are notices issued by the MLIT), and a registration of real property-related specified investment management, a sub-category of discretionary investment management services.

iv Hedge funds

The rationale behind hedge fund regulation is to protect investors in light of the complexity and high risks associated with hedge fund products, and to protect the stability of financial systems. The latter point arises as it is felt that hedge funds, which are significantly sized entities, complicated in investment techniques and closely integrated with financial systems, pose a potential systemic risk if not appropriately regulated.

Regarding the protection of investors, hedge funds are subject to the same regulations applicable to other financial products. For example, if a hedge fund is

structured as a collective investment scheme, or a Japanese or foreign limited partnership, the marketing of the hedge fund in Japan by its manager will be treated as self-solicitation and require registration as a Type II financial instruments transaction business (unless the qualified institutional investors exemption is available); and the management of a hedge fund by its manager will be treated as self-management and require registration as a discretionary investment management business (unless the qualified institutional investors exemption or the limited Japan relationship exception is available).

Currently no hedge fund-specific regulations exist that attempt to maintain financial system stability; however, extensive discussions continue as to how best to regulate hedge funds and limit systemic risk.

v Private equity

Both partnerships under the Civil Code of Japan and investment business limited partnerships under the Investment Business Limited Partnership Act are commonly used for private equity funds. These partnerships are treated as collective investment schemes and are subject to the same regulations on marketing (self-solicitation) and management (self-management).

VII TAX LAW

Below is a summary of the general taxation system of Japan currently in effect in relation to investment funds and other asset management activities. Tax treatment may vary according to the type of investor, the fund and other factors, and may be affected by subsequent changes in any relevant tax laws or tax authority decisions.

i Taxation of investment funds

Investment trusts

A securities investment trust and a publicly offered investment trust will not be subject to taxation with respect to any profits gained through the management of the trust property. A securities investment trust means an investment trust that invests more than 50 per cent of its assets in securities based on the instructions of the settler.

In the case of investment trusts other than securities investment trusts and publicly offered investment trusts, the trustees, rather than the trusts themselves, will be subject to corporation tax with respect to profits gained through the management of the trust property.

Investment corporations

Investment corporations will, in principle, be subject to corporation tax with respect to profits gained through the management of assets. However, if an investment corporation meets certain requirements, any distribution will be treated as a loss when calculating the investment corporation's income for the business year. As a result, the tax imposed on profits can be minimised. The requirements referred to above include that the investment corporation's issued equity is held by 50 or more investors, or by financial institutions only; the amount of its equity interests solicited in Japan exceeds 50 per cent of the total amount thereof; and distributed amounts in a single business year

exceed 90 per cent of the total amount of the investment corporation's distributable profits in that business year.

Collective investment schemes

Partnerships, silent partnerships, investment limited partnerships and limited liability partnerships are not subject to taxation. However, the relevant entity's partner will be subject to taxation with respect to profits gained through the management of assets thereof.

Under Japanese tax laws, a foreign entity similar to the above will not, in principle, be subject to taxation with respect to profits gained through the management of assets thereof. Recently, however, the Supreme Court of Japan ruled that Delaware limited partnerships should be classified as corporations for tax purposes. This is the first Supreme Court decision to established criteria for foreign entity classification. The Court explained that to determine if an entity is a corporation for tax purposes, one needs to consider if the entity has the legal attributes of a separate taxpayer, focusing on the rights and obligations relating to the entity's activities. The Court said that the first question is whether the entity is clearly defined under the law of incorporation as a corporation, or simply as an aggregate of its members. The second question is whether the entity can separately have a proprietary interest in its assets, and be liable for debts and obligations incurred as a result of its legal acts under the law of incorporation. Where an entity is deemed to be a foreign corporation, the entity's partner may not deduct the entity's losses from their tax returns.

ii Taxation of investment managers

An investment manager that is a corporation will be subject to corporation tax, and an investment manager who is an individual will be subject to income tax, with respect to any management fees or similar compensation received.

iii Taxation of overseas investors

A non-resident investor or a foreign corporate investor (an overseas investor) will currently, in principle, be subject to income tax or corporation tax as follows with respect to income obtained from sources within Japan.

Investors in an investment trust

An overseas investor investing in an investment trust will be subject to income tax at a rate of 15.315 per cent with respect to distributions made by an investment trust.

In addition, overseas investors investing in investment trusts will be subject to income tax or corporation tax at a rate of 15.315 per cent, with respect to capital gains from cancellation or redemption of beneficial interests. These tax rates may be affected by relevant tax treaties.

Investors in investment corporations

Currently, an overseas investor investing in an investment corporation will be subject to income tax at a rate of 15.315 per cent with respect to distributions made by the investment corporation.

In addition, a non-resident individual investor, having no permanent establishment in Japan, will not be subject to income tax with respect to capital gains arising from the transfer of an equity interest (except in certain limited cases, such as a transfer of shares of real estate-related corporations). Even where a non-resident individual investor is subject to income tax with respect to capital gains arising from the transfer of an equity interest, the tax rate may be affected by a relevant tax treaty.

Investors in collective investment schemes

Under Japanese tax laws, an overseas investor investing in a partnership, investment limited partnership or limited liability partnership will be subject to income tax at a rate of 20.42 per cent with respect to distributions of profits thereof if such investor is deemed to maintain a permanent establishment in Japan by the relevant tax authorities. The tax rate may be affected by a relevant tax treaty. However, in the case of an investment limited partnership, if an overseas investor meets certain requirements (including that such investor is a limited partner and is not the direct executor of the business of the investment limited partnership), the investor may be deemed not to maintain a permanent establishment in Japan if it files an application on this basis with the tax authority.

An overseas investor investing in a silent partnership, with or without a permanent establishment in Japan, will be subject to income tax at a rate of 20.42 per cent with respect to distributions of profits thereof.

VIII OUTLOOK

As mentioned above, total assets under management by Japanese investment trusts reached ¥100 trillion in May 2015, but this is only about 5 per cent of the total value of Japanese household assets. Accordingly, there remains room for a further increase of assets under the management of investment trusts. As a result, the FSA is likely to continue to push towards 'upgrading asset management capacity' of individual financial institutions, and review whether financial institutions, under their customer-oriented policy, are providing financial products and services that are genuinely beneficial for customers (as discussed in Sections I and V, *supra*).

The positive outlook for further investment means that a number of investment management companies are expected to be set up by financial institutions, including Japanese regional banks. One example is the asset management company due to be established by the Japan Post Group.

It is also worth noting that the FSA has listed concrete measures for monitoring enhanced international corporation under which it will participate more actively in discussions of international financial regulation; make its supervision more effective and efficient through enhanced cooperation with foreign authorities; and continue to upgrade its supervisory approaches with reference to those used by other regulators.[7] This push towards cooperation with foreign authorities is likely to mean that the FSA

7 FSA, Highlights of the Financial Monitoring Policy for 2014–2015, September 2014.

will have access to greater quantities of information regarding global asset management companies operating in Japan.

As to the scope of non-QIIs who are able to invest in a QII-targeted fund operator, it is worth paying attention to whether the range of non-QIIs is limited, as the Financial System Council's WG report dated 28 January 2015 mentions that fund management for general individual investors may be made under a crowd-funding investment type[8] rather than as activities of a QII-targeted fund operator.

8 Crowd-funding regulations were introduced by the May 2014 amendments to FIEA.

Appendix 1

ABOUT THE AUTHORS

YASUZO TAKENO

Mori Hamada & Matsumoto

Yasuzo Takeno is a partner at Mori Hamada & Matsumoto. Since the early 1990s, he has had extensive experience in advisory work for both domestic and foreign investment managers and investment funds businesses, including structuring, public offerings and private placements of offshore investment funds in Japan. He has represented issuers of foreign investment trusts established in the Cayman Islands, Luxembourg, Ireland and other jurisdictions, providing advice on legal and execution issues where issuers offer their units, either publicly or privately, in Japan. His investment fund work also covers legal advice on the day-to-day management of investment fund businesses. As well as his work dealing with asset management, his practice spans corporate finance activities and financial regulation. He obtained his LLB from Waseda University in 1985 and his MLitt from Oxford University, Worcester College, in 1993. He was admitted in Japan in 1987 and speaks Japanese and English.

FUMIHARU HIROMOTO

Mori Hamada & Matsumoto

Fumiharu Hiromoto is of counsel at Mori Hamada & Matsumoto and advises on an extensive range of financial transactions and financial regulatory matters, including asset management, investment funds (including public offering and private placement of foreign domiciled investment funds), real property investments (including inbound investments using a TK-GK (a collective investment scheme) or a TMK (specified purpose company for asset securitisation) with leveraged debt financing), health-care property investments (including hospitals and nursing care facilities), banking, derivatives and dispute resolutions relating to financial transactions. He received his LLB from the University of Tokyo in 1995 and his LLM from Columbia University School of Law in 2003. He also worked with Kirkland & Ellis in Chicago from September 2003 to

August 2004. He is admitted in Japan (1997) and New York (2004) and speaks Japanese and English.

MORI HAMADA & MATSUMOTO
Marunouchi Park Building
2-6-1 Marunouchi, Chiyoda-ku
Tokyo 100-8222
Japan
Tel: +81 3 5220 1844/+81 3 5223 7723
yasuzo.takeno@mhmjapan.com
fumiharu.hiromoto@mhmjapan.com
www.mhmjapan.com