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FINANCIAL SERVICES & TRANSACTIONS GROUP NEWSLETTER

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First Report of the "Working Group on Capital Market Regulations" of the Financial System Council[1] and Bill to Amend the Financial Instruments and Exchange Act

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On December 23, 2020, the "Working Group on Capital Market Regulations" (the "WG") of the Financial System Council of the Financial Services Agency of Japan published its first report (the "Report"). The Report summarizes the results of the WG's review of system improvement measures aimed at: (1) accepting foreign investment managers; and (2) relaxing of the foreign corporate client information firewall between banks and securities firms to regulate the exchange of information. In addition, a bill to amend the Financial Instruments and Exchange Act in accordance with the Report (the "Bill") was submitted to the Diet on March 5, 2021. This newsletter provides an outline of the system reforms proposed in the Report and the Bill.

1. Background

Japan has taken steps to position itself as an international financial hub, but must further accelerate improvements in the business environment to welcome foreign financial institutions, particularly foreign investment managers. The Report[2] summarizes the results of the WG's review of the following matters in relation to that goal:

(1) Improvements to the system in order to welcome foreign investment managers; and
(2) Relaxation of the foreign corporate client information firewall between banks and securities firms to regulate the exchange of information.

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[1] In February 2021, AMT issued a newsletter about this topic in Japanese. It can be found on our website (see below link). This newsletter is not a translation thereof.
https://www.amt-law.com/publications/detail/publication_0022631_ja_001

[2] https://www.fsa.go.jp/singi/singi_kinyu/tosin/20201223/houkoku.pdf (available only in Japanese)

On March 5, 2021, following recommendations suggested in the Report, the Bill including the amendments to the Financial Instruments and Exchange Act in connection with the two proposals to improve the system (the “Proposed Amendments”) was submitted to the Diet.[3]

2. Improvements to the system in order to Welcome Foreign Investment Managers

2-1 Current System and Background

In principle, any person intending to conduct an investment management business in Japan is required to be registered with the relevant authorities as a financial instruments business operator under the Financial Instruments and Exchange Act (the "FIEA") (Article 29 of the FIEA).[4,5]

The Report proposes two new systems aiming to ease the requirements under the FIEA with respect to investment management businesses: (1) creation of a category of fund management business that primarily manages foreign funds, as described in section 2-2 below; and (2) a special exemption during a transition period for investment managers that solely manage foreign funds, as described in section 2-3 below.

2-2 Creation of a Category of Fund Management Business that Primarily Manages Foreign Funds (the “New System”)

(1) Purpose of the system improvement

The Report states that if an investment manager's clients are primarily foreign corporations and individuals with certain assets residing overseas (collectively, the "Foreign Investors"), the investment manager should: (i) not be required to obtain investments from at least one qualified institutional investor, with the others being limited to certain sophisticated investors; (ii) not be subject to any restrictions on the number of investors; and (iii) be able to start a business in Japan by notifying the relevant authorities.[6]

The Proposed Amendments define the New System as “the specially permitted business for foreign

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[3] https://www.fsa.go.jp/common/diet/index.html (available only in Japanese)

[4] In principle, a foreign investment manager intending to provide investment management services to investors in Japan is required to be registered under the FIEA.

[5] However, an investment management business handling a limited number of investors can benefit from certain exceptions: (i) an investment management business targeting qualified institutional investors (i.e., "investment management business for professionals") (Article 29-5 of the FIEA); and (ii) a specially permitted business for qualified institutional investors (i.e., "funds for professionals") (Article 63 of the FIEA).

[6] Registration under the FIEA is not required for a foreign investment manager with no physical presence in Japan that is not providing investment management services to domestic investors.

investors, etc."[7] and each of the investment managers notifying the regulator as to their intent to utilize it as "a notifier of the specially permitted business for foreign investors, etc."[8].

(2) Types of investment management businesses

An investment manager registered in Japan may conduct an investment management business categorized under the following vehicle types: (a) self-management of interests in partnership-type collective investment schemes; (b) investment management for investment trusts and foreign investment trusts; (c) investment management for domestic and foreign investment corporations and (d) investment management pursuant to a discretionary investment contract. The Report suggested that, initially, it would be appropriate to apply the New System only to self-management of interests in partnership-type collective investment schemes. Thus, the New System is not expected to apply to the three other categories of investment management businesses.[9]

Accordingly, Article 63-8, Paragraph 1 of the Proposed Amendments stipulates that "the specially permitted business for foreign investors, etc." is only applicable to the self-management of interests in partnership-type collective investment schemes.

(3) Conduct regulation, supervisory actions, etc.

As part of its role to protect investors, the FIEA provides that investment managers are subject to a duty of loyalty and duty of care, and are otherwise subject to regulations relating to conduct and other issues. In addition, investment managers may be subject to a business improvement order or other supervisory actions or on-site inspections by the relevant authorities. The Report concludes that it would be appropriate to treat investment managers who are subject to the New System in the same manner as ordinary investment managers. Further, the Report indicates that investment managers intending to utilize the New System should be required to have a physical presence in Japan.

Articles 63-9, 63-12, 63-13 and 63-14 of the Proposed Amendments stipulate that the activities of "a notifier of the specially permitted business for foreign investors, etc." are subject to certain regulations under the FIEA and to supervisory action by the relevant authorities.

(4) Investments procured from domestic investors

The Report states that allowing investments procured from certain domestic investors (i.e., professional investors) is appropriate only to the extent that the ratio thereof is below 50%.

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[7] Article 63-8 of the Proposed Amendments.

[8] Article 63-9 of the Proposed Amendments.

[9] The Report contains a note stating that certain WG members believe that, if warranted, investment management businesses pursuant to discretionary investment contracts should be included in the new category.

Article 63-8, Paragraph 2 of the Proposed Amendments stipulates that “the foreign investors, etc.” include not only certain foreign investors, but qualified institutional and certain other investors as well.

(5) Scope of the subject businesses

The Report indicates that the New System should apply to domestic investment managers to the extent that their clients are primarily Foreign Investors and that they otherwise satisfy the requirements for the New System.

Article 63-8, Paragraph 1 of the Proposed Amendments does not exclude domestic investment managers from “the specially permitted business for foreign investors, etc.”

Article 63-9, Paragraph 6 of the Proposed Amendments stipulates that in order to conduct “the specially permitted business for foreign investors, etc.”, the investment manager must have a business office in Japan. As establishment of a business office in Japan is required in order to qualify under the “specially permitted business for foreign investors, etc.”, a relevant foreign investment manager would be eligible to use such category only if it establishes a business office or a subsidiary in Japan. Otherwise, irrespective of whether it primarily manages foreign funds, such investment manager would not be eligible to use this category.

(6) Whether the relevant investment managers may engage in solicitation for acquisition

The Report concludes that after filing a notification with the relevant authorities[10], new entrants under the New System should be able to solicit Foreign Investors or the above-mentioned certain domestic investors for acquisition of interests in partnership-type collective investment schemes.

Accordingly, Article 63-8, Paragraph 1, Item 2 of the Proposed Amendments stipulates that “the specially permitted business for foreign investors, etc.” includes solicitation for the acquisition of interests in partnership-type collective investment schemes.

2-3 Special Exemption during a Transition Period for Investment Managers Solely Managing Foreign Funds (the “New Special Exemption”)

(1) Purpose of the system improvement

Given that an investment manager performing investment management services overseas and solely managing foreign funds already has a track record and obtained a license or approval from the relevant foreign authorities, the Report proposes the introduction of a "New Special Exemption" whereby such

[10] In principle, under the FIEA, registration for Type II Financial Instruments Business is required for anyone intending to solicit the acquisition of interests in partnership-type collective investment schemes in Japan.

manager may, by filing a notification, continue that business in Japan for a certain period until it obtains a registration under the FIEA. .

The Proposed Amendments define the New Special Exemption as “the specially permitted business for transition period.”[11]

The Report does not expressly state whether the scope of the investment management business covered by the New Special Exemption should be limited.

The Proposed Amendments stipulate that “the specially permitted business for transition period” is applicable to: (a) self-management of interests in partnership-type collective investment schemes; (b) investment management for foreign investment trusts; and (c) investment management pursuant to a discretionary investment contract.

Further, the Report does not clarify whether, as a condition for being able to conduct business in Japan under the New Special Exemption, the relevant foreign managers: (i) have to establish a presence in Japan; or (ii) may provide investment management services to Japanese investors.

With regard to (i) above, Article 3-3, Paragraph 3 of the supplementary provisions of the Proposed Amendments stipulates that, in order to conduct “the specially permitted business for transition period”, the investment manager must have a business office in Japan.

With regard to (ii) above, Article 3-3, Paragraph 6 of the supplementary provisions of the Proposed Amendments stipulates that the “foreign investors, etc.” to whom the investment manager may provide investment management services during “the specially permitted business for transition period” include, in addition to foreign investors, certain domestic investors to be specified under a relevant cabinet order and cabinet office ordinances.

(2) Permitted business period and status as a temporary measure

The Report suggests that it would be appropriate to set the period during which the relevant foreign investment managers may operate under the New Special Exemption at approximately five years and require them to transition to a permanent category (e.g., being registered under the FIEA) by no later than the expiration of such period. The Report does not clarify whether during the period of the New Special Exemption the relevant foreign investment managers would be subject to conduct regulations and supervisory action under the FIEA.

Article 3-3, Paragraph 4 of the supplementary provisions of the Proposed Amendments stipulates that the conduct of the entity submitting a notification to engage in “specially permitted business for transition

[11] Article 3-3 of the supplementary provisions of the Proposed Amendments.

period" will be subject to certain regulations and supervisory action under the FIEA during "the specially permitted business for transition period."

The Report suggests introducing the New Special Exemption as a temporary measure for approximately three to five years rather than making it a permanent exemption.

Accordingly, Article 3-3, Paragraph 2 of the supplementary provisions of the Proposed Amendments stipulates that the notification for engaging in "specially permitted business for transition period" should be submitted no later than five years following the Proposed Amendments' enforcement date (otherwise, this interim exemption may no longer be available).

(3) Eligibility of investment managers

The Report concludes that eligibility for the New Special Exemption should be subject, among others, to the satisfaction of the following requirements: (a) while operating in Japan, the foreign investment manager must maintain a license, approval, etc. from the relevant foreign authorities; (b) the foreign investment manager must have a track record overseas; and (c) the principal investments of its funds as a whole must be in foreign securities (i.e., the ratio of domestic securities to the portfolio as a whole is below 50%).

The above requirements are stipulated in Article 3-3, Paragraph 3, Item 1 of the supplementary provisions of the Proposed Amendments, but the details thereof will be set forth in a cabinet order and/or cabinet office ordinances.

Further, the Report indicates that an investment manager operating under the New Special Exemption may be legally required to have qualified personnel and necessary systems in place.

The above requirements are stipulated in Article 3-3, Paragraph 3, Item 1 of the supplementary provisions of the Proposed Amendments.

(4) Scope of foreign authorities granting licenses, approvals, etc.

The Report suggests that investment managers that are eligible for the New Special Exemption should be from a foreign jurisdiction that has, as a whole, the same market rules as those applicable in Japan and provides substantial financial supervision based on essentially the same principles as those adopted by the Japanese supervisory authorities.

Article 3-3, Paragraph 3, Item 1 of the supplementary provisions of the Proposed Amendments stipulates that an investment manager conducting activities pursuant to "the specially permitted business for transition period" exemption, must be licensed to engage in an investment management business in a foreign jurisdiction or region that imposes on investment managers an investor protection system comparable to Japan.

3. Relaxation of the foreign corporate client information firewall between banks and securities firms to regulate the exchange of information

The current FIEA and Cabinet Office Ordinance on Financial Instruments Business (“COOFIB”) establish a "*Ginsho* (i.e., banks – securities firms) firewall regulation." In principle, pursuant to that regulation, if “non-public information” regarding a client is shared between a bank and a securities company within the same financial group, that client's prior written consent must be obtained (Article 153, Paragraph 1, Item 7 of the COOFIB). However, “non-public information” relating to foreign corporate clients is subject to an opt-out rule and other special provisions, including one enabling receipt of the client's consent by email (Article 153, Paragraph 1, Item 7(a) of the COOFIB).

Based on statements made by the WG in the Report, non-public information relating to foreign corporate clients should be excluded from the scope of the regulation on the exchange of information.

Accordingly, on March 26, 2021, the draft amendments to the COOFIB, including the proposed exclusion of information on foreign corporate clients from the definition of “non-public information”, was published for public comments.

4. Future Prospects

As mentioned above, on March 5, 2021, following recommendations in the Report, the Proposed Amendments, including the New System and the New Special Exemption, were submitted to the Diet. Aiming to relax the foreign corporate client information firewall between banks and securities firms and regulate the exchange of information, the draft amendments to the COOFIB are expected to become effective this year following the public comment period.

The Report suggests that the WG will continue to consider the remaining issues, such as ways to provide growth capital and regulate the exchange of information relating to domestic clients.

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