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Investment Funds 2022

Japan: Trends & Developments
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Trends and Developments

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The COVID-19 Pandemic and Outlook for 2022

Japanese stocks fluctuated greatly during 2021, often impacted by the ebb and flow of the pandemic during the year. The Nikkei Stock Average (commonly known as the Nikkei 225) started at JPY27,575.57 at the beginning of 2021 and hit JPY30,714.52 on 16 February 2021, which was the highest price in more than 30 years after the burst of Japan's bubble economy. Thereafter, the index gradually fell as concerns rose regarding the pandemic's impact on economic recovery. After the fourth state of emergency was declared in Tokyo on 9 July 2021, the Nikkei 225 fell to JPY26,954.81 on 10 August 2021, its lowest point in 2021. After a series of rises and falls over the subsequent months, the index rose again after the Liberal Democratic Party won a stable majority in the Lower House at the general election in November 2021. By the end of December 2021, the Nikkei 225 closed at JPY28,791.71, representing a 4.9% rise from the end of December 2020.

In November 2021, Prime Minister Fumio Kishida announced a JPY56 trillion stimulus package to counteract the effects of the pandemic on the Japanese economy. While it is hoped that this will improve Japan's economic outlook in 2022, Japan and other countries across the globe continue to face multiple challenges ranging from the threat of new COVID-19 variants, to supply chain disruptions and inflation. Central banks, including the Bank of Japan, will be reviewing their policies in light of these factors. Additional global economic and political risk factors also loom, such as rising tension between the US and China and the Russia-Ukraine border crisis.

All of the above can be expected to have an impact on the performance of the markets and the recovery of the Japanese economy in 2022.

Investment Environment In Japan and Developing Trends

Investment funds in Japan generally

The most widely used form of investment fund in Japan is an investment trust (*toushi shintaku*), created pursuant to the Japanese Act on Investment Trusts and Investment Corporations (Investment Trust Act). Investment trusts are marketed and sold on both the retail market (through public offerings) and the institutional market (mostly through private placements). They are also made available to Japanese investors through various other channels, such as Defined Contribution (DC) pension programmes, Variable Annuity (VA) insurance products offered by life insurance companies, and "wrap accounts" offered by securities brokers and asset management companies. Most exchange-traded funds (ETFs) listed and traded on the Tokyo Stock Exchange also take the form of investment trusts.

According to statistics published by the Investment Trusts Association, Japan (JITA), the net asset value (NAV) of all publicly offered investment trusts as of 31 December 2021 was approximately JPY164.5 trillion, invested in 5,923 funds (excluding investment corporations). For the same period, the NAV of all privately placed investment trusts was approximately JPY110.74 trillion, invested in 8,179 funds (excluding investment corporations). Among the publicly offered investment trusts, 212 funds were ETFs, with a total NAV of approximately JPY62.4 trillion.

The Investment Trust Act also provides for the formation of the statutory investment corporation (*toushi houjin*) as a special purpose vehicle for investment funds. An investment corporation that is primarily used for real estate investments is popularly known as a Japanese Real Estate Investment Trust (J-REIT), which is something of a misnomer since all existing J-REITs use the form of an investment corporation rather than being structured as trusts. According to JITA statistics, the NAV of all publicly offered J-REITs as of 30 November 2021 was approximately JPY11.1 trillion (invested in 62 funds, all listed on the Tokyo Stock Exchange) and there were 44 privately placed J-REITs, with a total NAV of approximately JPY2.7 trillion.

A number of offshore investment funds domiciled in jurisdictions such as the Cayman Islands, Luxembourg and Ireland are offered in Japan, through public offerings as well as private placements. According to statistics published by the Japan Securities Dealers Association (JSDA), 789 outstanding offshore investment funds (including sub-funds under the same umbrella) were distributed publicly in Japan as of 31 December 2021. The NAV of all these funds attributable to investors in Japan was approximately JPY6.9 trillion in aggregate. As of 30 September 2021, funds domiciled in the Cayman Islands and Luxembourg accounted for 53.1% and 34.1% of the total NAV of publicly offered offshore funds, respectively, with the remainder being invested in offshore funds domiciled in Ireland.

Low-cost/passive/no-load funds

Since 2000, index funds have attracted more interest in the Japanese market by expanding their investments to include foreign bonds and J-REITs. They expanded their horizons to balanced funds, theme funds and ESG-related funds. Index funds, which can invest in a variety of investments at a relatively low cost, are expected to continue to grow.

Due to pressure to reduce management fees in 2021, Japan saw an in-flow of low-cost funds and the expansion of passive and no-load funds (with no sales charge). The total NAV of passive funds among publicly offered open-end stock investment trusts (excluding ETFs) increased for eight consecutive months, exceeding JPY15 trillion by May 2021, representing an increase of more than double since 2016. At the end of June 2021, the share of passive funds among all domestic funds rose to 19.96%, up from 13.21% in 2016.

As a result of these trends, competition is intensifying among index funds to offer products carrying lower management costs. The total expense ratio of one such fund recorded an all-time low fee level of 0.10% in 2021.

ESG investing

ESG investment began to gain broad attention in Japan from around 2010. The domestic ESG-related fund market grew rapidly in 2021, with the number of new funds nearly doubling compared to 2020. Approximately one in five publicly offered open-end stock investment trusts launched in 2021 was ESG-related. Previously, the NAV of an ESG-related fund at launch typically did not exceed JPY30 billion, but in 2018 funds with a NAV of nearly JPY70 billion began to appear.

Japan's private savings challenge

Japan is the third wealthiest economy and the third largest pension market in the world. Japan's private savings rate is particularly noteworthy, with cash equivalents on Japanese household balance sheets currently amounting to more than USD18 trillion in aggregate. This reflects the strong preference of Japanese households to keep money "safe" in the bank or "principal guaranteed" or other low-yield investments, instead of investing in the stock market or other higher yielding investments that are perceived

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as being risky. Recognising the need to encourage a "shift from saving to investment" in order to foster well-balanced financial assets among Japanese households, and to promote economic growth, the Japanese government has been pursuing various initiatives towards this purpose for some time.

One such initiative is the Nippon Individual Saving Account (NISA) system introduced in January 2014, modelled after the Individual Saving Account system in the United Kingdom. Under the basic NISA system (Basic NISA), individual investors (aged 20 or above) are given a tax exemption on dividends and capital gains derived from listed shares and publicly offered investment trusts. In 2015, the "Junior NISA" system was also introduced, under which minors (under 20 years of age) are allowed to open specially designed NISA accounts. Furthermore, in January 2018, the monthly investment (*tsumitate*) NISA (now called an Accumulation NISA) was introduced as an alternative to the Basic NISA.

According to JSDA statistics, as of 30 September 2021, the numbers of Basic NISA accounts and Accumulation NISA accounts opened with JSDA member securities brokers have steadily increased to approximately 7.62 million and 3.05 million, respectively, representing increases of 2.8% and 76.6% compared to the end of 2020. The amounts accumulated through investments in Basic NISA accounts (from 2014 through 30 September 2021) and Accumulation NISA accounts (from 2018 through 30 September 2021) are approximately JPY16.63 trillion and JPY755.4 billion, respectively.

Backed by a global stock market rally, at the end of June 2021 the aggregate NAV of publicly offered stock investment trusts (excluding ETFs) exceeded JPY80 trillion, representing a JPY10 trillion increase from the end of December 2020. Moving with this trend, a number of monthly participants enrolled in "iDeCo", a defined contribution pension plan governed by the Defined Contribution Pension Act, which maintained a high level of participation, exceeding 40,000 participants for the seven consecutive months from February 2021. This represents a 15% increase of monthly new participants in November 2021 compared to November 2020.

Recent Developments – Financial Centre Initiative

An exciting initiative that has gained momentum over the last few years through co-operation between Japanese governmental agencies at the national and local government levels is the effort to expand Japan's role on the world stage as an international financial centre. Apart from the nationwide project, at the local level there is also the Tokyo Metropolitan Government's FinCity.Tokyo initiative, which seeks to establish Tokyo as a financial hub in Asia. These initiatives aim to attract talented financial professionals and investment from all over the world to Japan and, by doing so, also tackle Japan's private savings challenge.

Exemption from registration

Measures arising from these initiatives include an exemption for foreign investment managers from registration under the Financial Instruments and Exchange Act of Japan (FIEA), subject to the satisfaction of specific requirements. As a general rule, a person who intends to be engaged in an investment management business in Japan is required to register for such purposes under the FIEA. The path to registration can be lengthy, even for a foreign asset management firm with a proven track record overseas. Under the newly introduced exemption, instead of obtaining the registration, an investment manager may engage in investment management business in Japan by submitting a notification to the regulator, provided that the investment manager has sufficient staff and an appropriate organisation structure.

There are two types of exemptions:

- a foreign investor exemption; and
- a foreign investment manager temporary exemption.

A foreign investor exemption is available to managers of collective investment schemes, such as general partners of limited partnerships. One requirement for qualifying for a foreign investor exemption is that the scope of investors in such collective investment scheme is limited to foreign investors, such as foreign corporations, foreign residents satisfying certain requirements, pension funds subject to foreign laws and professional (including Japanese) investors, as defined under the FIEA.

A foreign investment manager temporary exemption is available to investment managers that have approvals, licences or registrations as a fund management business in a prescribed foreign jurisdiction (such as the United States, the United Kingdom, Australia, Singapore and Hong Kong) and a track record of no less than three years in the asset management industry. While this temporary exemption allows an investment manager to carry out the same investment management business in Japan as the manager conducts outside of Japan under the relevant approval, licence or registration of the foreign jurisdiction, the scope of investors that the foreign investment manager may retain as clients in Japan is limited to foreign investors, such as foreign corporations, foreign residents, officers and directors, parent companies and subsidiaries of that investment manager, and Japan resident clients must generally be limited to investment managers and trust banks registered under the FIEA.

It should also be noted that this type of exemption is transitional, expiring up to five years from the date of the filing of the notification. In order to continue the investment management business in Japan following the expiration of the temporary exemption period, the foreign investment manager must either apply for a registration as an investment manager under the FIEA under the traditional route or rely on another exemption available under the FIEA.

The Financial Market Entry Office

As a further measure to attract financial firms to Japan, Japan's financial regulator, the Financial Services Agency (FSA), established a Financial Market Entry Office in January 2021 as a centralised consultation centre for overseas financial companies (principally those engaged in asset management business) considering doing business in Japan. The FSA touts the office as a single point of contact for such companies, offering consultation in English on various matters, ranging from financial licensing to registration procedures.

Other measures

In addition to the foregoing, various changes to corporate, inheritance and income taxes have also been adopted to make relocation to and residency in Japan more attractive to businesses and individuals engaged in the asset management industry.

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Anderson Mori & Tomotsune is one of the largest and most international Japanese law firms. It is best known for its long history of advising overseas companies doing business in Japan and in cross-border transactions. The main office in Tokyo is supported by two further offices in Japan (Osaka and Nagoya) and seven overseas. AMT has considerable experience in matters relating to investment funds, including expertise in investment trusts, investment corporations such as J-REITs, infrastructure funds, exchange-traded funds, partnerships and other forms of collective investment schemes. The firm works with increasingly diversified international and Japanese-based investment funds, including private equity funds, venture capital funds, hedge funds, funds of funds and commodity funds. Consisting of about 15 partners and 40 associates, the team provides comprehensive advice on all stages of the procedures to which investment funds are subject, and helps clients to navigate a broad range of regulatory matters relating to asset management.

AUTHORS

Kunihiko Morishita is a partner at Anderson Mori & Tomotsune, who works primarily on domestic and international banking, securities and asset management matters. He is a member of the Financial Law Board, which is an influential advisory body regarding financial law matters sponsored by the Bank of Japan. Kunihiko has extensive experience in representing financial institutions, including investment management companies, before the Financial Services Agency and other Japanese regulatory authorities. He regularly advises a number of multinational financial institutions, located within and outside of Japan, in relation to securities, trusts, insurance and asset management regulatory issues.

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