Progress Report on **Enhancing the** Asset Management Business 2020

Financial Services Agency, Japan (JFSA)

June 2020

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I. Current status and issues

There have been high expectations for the asset management industry in Japan that it would contribute to building personal (household) assets steadily by utilizing the abundant capital held by households, which is expected to be invested into the financial markets. Such investments would support the growth of the Japanese economy and global economies, and consequently Japanese households will receive higher returns on their investments. However,

1. The rapid growth of Exchange Traded Funds (ETFs) and passive funds in the global space has led to fee competition and industry-wide restructuring, i.e., shifting to an oligopoly-like industrial landscape in the asset management industry. **Japanese asset management companies now face intensifying competition.**

2. **The average performance of Japan's publicly offered active investment trusts(*)** is not **commensurate with the trust fees and other costs**. Consequently, the asset management business **has not gained enough confidence and support from customers, resulting in** the sluggish growth in assets under management (AUM) of the publicly offered investment trust market.

(*) mutual fund equivalent

II. Key challenges

Asset management companies in Japan are expected to introduce resolute plans and actions to address the following key challenges to achieve favorable medium to long-term performance, which would help them gain the credibility and support of their customers by contributing to customers' asset accumulation, and solidify company revenue bases.

1. Organizational governance: A full-fledged supervising function on organizational and fund management from the perspective of prioritizing customer's interests seems inefficient. Does each parent company of each asset management company and other affiliated group companies within the same financial conglomerate fully acknowledge the key issues of the asset management business, and do they extend collaborative support to deal with those issues?

2. Managerial/Operational structure: A managerial/operational structure that can prioritize customers interests and values of long-term investment seems not fully established and implemented.

3. Corporate vision and core competence: Are there clear definitions of corporate vision and core competence as an asset manager? Are the efforts to implement this corporate vision and core competence making sufficient progress, if any?

4. Business operations: Are the business operations to implement the corporate vison and core competence and prioritizing customers' interests and investment efficiency fully established and implemented?

By addressing these challenges, expected outcomes include: (1)strengthening investment capabilities; (2)focusing on products that can achieve favorable medium and long-term performance, without unduly increasing the number of funds; and (3)implementing rigorous fund management, including redeeming or consolidating unprofitable and/or small-sized funds underperforming for mid- to long- periods.

III. Course of action

FSA will continue to hold dialogues with the management teams of domestic asset managers and their parent companies (if applicable), so that each makes further effort to promote the following initiatives:

1. Develop and implement a governance structure that prioritizes customers' interests.
2. Establish managerial/operational structure that enables "customer's-interests-first and long-term-investment-value-oriented" business conduct by the management team with experience in the asset management business.
3. Clarify corporate vision and core competence, and take resolute actions toward implementing them.
4. Establish and improve business operations regarding HR evaluation and compensation, product governance, including fund development, launch, and administrations.

Promoting the initiatives listed above enables asset managers to provide customer-needs-oriented products, achieve robust mid- to long-term performance, gain the support and confidence of customers, and reinforce the company revenue base. To that end, it is imperative to (1) strengthen competence in investment capabilities, (2) focus on products that can deliver robust consistent performance over the medium to long term, without unduly increasing the number of products, and (3) exercise rigorous management by streamlining funds via redeeming or consolidating unprofitable and/or small-sized investment trusts underperforming for a medium to long period of time.

FSA will also hold dialogues with independent and other distinctive asset managers that achieve favorable consistent performance to study and discuss the contributing factors and robustness of their performance.

FSA will also study, analyze, and publicize the status of privately placed investment trusts and discretionary investment management for institutional investors, reinforce "visualization" of the performance of publicly offered investment trusts, and promote measures to encourage new entry into the asset management market.

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- Full Report -

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Introduction

- The JFSA's mission is to contribute to national welfare by securing the sustainable growth of national economy and wealth. The key elements in pursuing this mission include smooth capital circulation, which can enhance the value of "Corporate Japan" and bring benefits to retail investors via capital/income gains. This virtuous cycle is achieved if all constituents of the "holistic investment-value-chain" play their expected roles and functions effectively.

- In this "holistic investment-value-chain," the asset managers' role is crucial, i.e., Japanese asset managers also invest in the financial market with capital entrusted by retail investors. However, typical Japanese asset managers have a unique history, i.e., many were founded as subsidiaries of finance conglomerates and expected to provide products for their parent companies and/or the retail sales companies within each conglomerate. This historic industrial landscape is the main reason for the tendency of the industry to prioritize the enhancement of the conglomerates' revenues by offering financial products that carry relatively higher fees, and promote a short horizon turnover and products that can be sold in large scale in the retail market.

- Considering this, the FSA has engaged in a series of dialogues with major domestic asset managers and their parent companies to discuss their (1) Organizational governance; (2) Managerial/Operational structure; (3) Corporate vision and core competence; and (4) Business operations. The FSA expects that these dialogues would encourage asset managers to give the highest priority to their customers' interests, offer more customer-needs-oriented products, and strengthen their investment management capabilities to achieve favorable medium to long-term performance. These efforts would result in gaining credibility and support from customers by contributing to customers' asset accumulation, and it would strengthen the company's revenue bases.

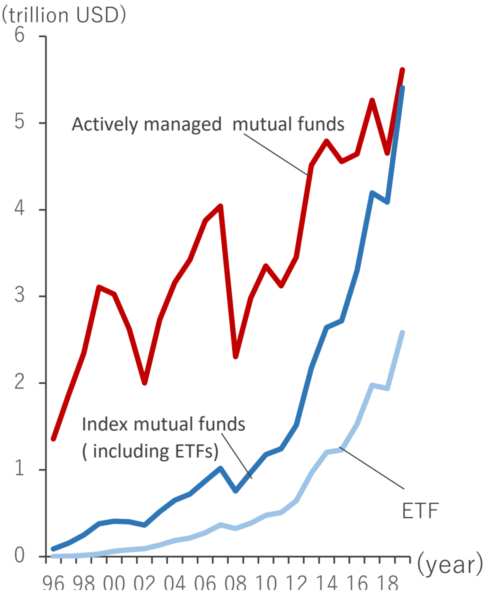
- This progress report outlines the current status and issues of the asset management business, key challenges identified through interviews with overseas asset managers and the dialogues with domestic asset managers, and the potential actions going forward. Asset managers and their parent companies are expected to undertake further initiatives to address the key challenges mentioned above, considering their company-specific situations.

- With COVID-19 profoundly affecting the society and economy, it may also materially affect the financial markets and the asset management business. The FSA will study and analyze these influences going forward.

I. Current Status and Issues 1. Environment surrounding the asset management business - global perspectives
(1) Rapid growth of passive funds and oligopoly-like industry landscape

- The industry-wide AUM outstanding of ETFs and passive funds, which typically carry low fees, particularly U.S. equity funds, has rapidly increased (Figure A), boosting the AUM of asset managers that offer these funds.
- The fund sizes of asset managers benefiting from this industry-wide AUM growth increased enabled them to lower fees due to the economies of scale and thereby, enhance investment efficiency. This tendency triggered a recurring cycle, i.e., bigger funds attract more capital inflows due to the lower fees, shifting the industry to an oligopoly-like scenario, i.e., with fewer asset managers dominating the market. (Figure B) The continuing low interest rate environment and heightened regulatory disclosure requirements induced the investors' awareness of cost-efficiencies. Investors also observed that active funds in general could not outperform passive funds in the mid- to long-term. These are said to be the primary reasons of the industrial trend mentioned above.
- Consequently, a large scale capital shift has been observed in the UK, as a symbolic case of this trend. Asset managers in the UK traditionally boasting competitive active investment management lost mandates and this money flowed to US asset managers with passive funds and ETFs, which penetrated the UK market. (Figure C)

A. AUM of US Equity Mutual Funds



(Note) Mutual funds are the main components of the funds

(Source) Invest Company Institute

B. AUM of asset managers in global space

2010 (unit: one trillion USD)

rank	company	home country	net asset balance
1	BlackRock, Inc.	the U.S.	3.6
2	State Street Corporation	the U.S.	2.0
3	Allianz	Germany	2.0
4	Fidelity International	the U.S.	1.8
5	The Vanguard Group, Inc.	the U.S.	1.8
6	Deutsche Bank AG	Germany	1.6
7	AXA SA	France	1.5
8	BNP Paribas S.A.	France	1.3
9	J.P. Morgan	the U.S.	1.3
10	Capital Group	the U.S.	1.2
20	Nippon Life Insurance Company	Japan	0.7
30	National Mutual Insurance Federation of Agricultural Cooperatives	Japan	0.5
31	Mitsubishi UFJ Financial Group, Inc.	Japan	0.5

2018 (unit: one trillion USD)

rank	company	home country	balance
1	BlackRock, Inc.	the U.S.	6.0
2	Vanguard Asset Management, Limited.	the U.S.	4.9
3	State Street Corporation	the U.S.	2.5
4	Fidelity International	the U.S.	2.4
5	Allianz	Germany	2.2
6	J.P. Morgan	the U.S.	2.0
7	THE BANK OF NEW YORK MELLON CORPORATION	the U.S.	1.7
8	Amundi	France	1.7
9	Capital Group	the U.S.	1.7
10	AXA SA	France	1.6
28	Sumitomo Mitsui Trust Holdings	Japan	0.8
34	Nippon Life Insurance Company	Japan	0.7
41	Mitsubishi UFJ Financial Group, Inc.	Japan	0.6

(Note) The underlined in the above are asset managers with particular strength in passive investment and ETFs.

(Source) Willis Towers Watson

C. Annual capital inflow and outflow of UK asset managers

(unit: 100MM USD (millions of USD)

company	annual outflows and inflows in the U.K.(as of 2019)	home country	net asset balance in the U.K. (as of the end of 2019)
BlackRock, Inc.	91.2	the U.S.	1,616.0
Royal London Group	76.1	the U.K.	644.7
Vanguard Asset Management, Limited.	61.8	the U.S.	416.4
J.P. Morgan	26.2	the U.S.	233.7
Baillie Gifford	22.8	the U.K.	533.3
Invesco Ltd.	-122.7	the U.S.	550.4
Aberdeen Standard Investments	-114.5	the U.K.	381.5
M&G plc	-99.5	the U.K.	455.9
Schroders plc	-55.1	the U.K.	45.8
Artemis Investment Management LLP	-54.8	the U.K.	266.4

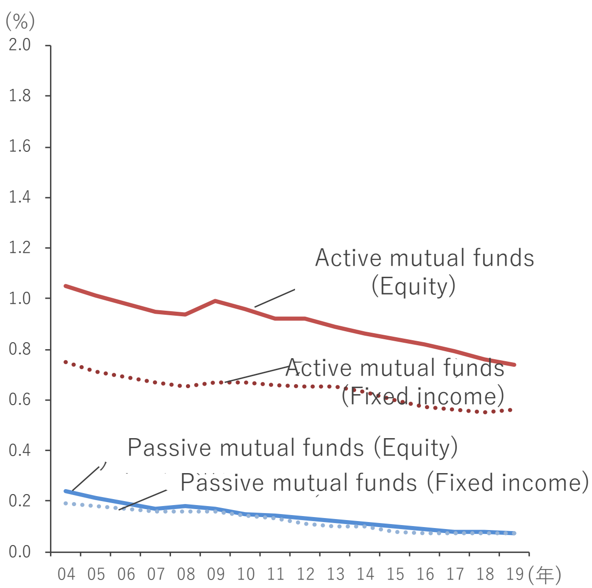
(Note) The underlined in the above are US-based asset managers with particular strength in passive management and ETFs.

(Source) Morningstar

I. Current Status and Issues 1. Environment surrounding the asset management business - global perspectives
(2) Intensifying competition and reactions taken of non-Japanese asset mangers

- Both active and passive fund fees have been declining in the US. The growth in fund size also contributed to lower the absolute level of management fees because of improved cost-efficiency from the economies of scale. (Figure A)
- The Industry-wide environment of ongoing oligopolization and declining fees puts pressure on asset managers, which have so far prioritized active investments, to tackle the declining fee income. This has led to a spate of consolidation among major asset managers to pursue economies of scale. (Figure B)
- Asset managers are trying to reshape their competitive edge by reassessing their strengths based on customers' perspective and strategically allocating management resources to refurbish those strengths. This is because maintaining the status-quo is not a wise strategy when responding to the intensifying market competition. For some financial conglomerates, the tightening capital adequacy rules for banking entities has forced them to strengthen their asset management business. (Figure C)

A. Expense Ratios of US Mutual Funds



(Note) Expense ratios are measured as asset-weighted averages.
(Source) Investment Company Institute

B. Examples of Merger/Consolidation of Asset Managers outside of Japan

(100MM USD (millions of USD)

period		company	Net asset balance
October 2016	the U.S.	Janus Capital Group, Inc.	1,890
	the U.K.	Henderson Global Investors Ltd.	1,360
December 201	France	Amundi	9,850
	Italy	Pioneer Investment Management SGRpA	2,430
March 2017	the U.K.	Standard Life	3,430
	the U.K.	Aberdeen Standard Investments	3,460
October 2018	the U.S.	Invesc, Ltd.	9,370
	the U.S.	Oppenheimer & Co. Inc.	2,460
February 2020	the U.S.	Franklin Resources, Inc.	6,490
	the U.S.	Legg Mason Investor Services	7,270

(Note) Net assets are calculated by weighting the trust fees of each fund by its net assets, as of the end of the year in which the merger was announced.
(Source) Figures of net trust assets are mainly based on the data from Willis Towers Watson, while that of the company from a merger of Oppenheimer and Invesco is based on their respective press releases.

C. Key Strategies of Overseas Asset Managers

- ✓ Pursuing a more distinct active strategy
- ✓ ESG-focused strategies and corporate engagements
- ✓ Focusing on alternative investments (private equity, private debt, infrastructure, real estate, farmland and others)
- ✓ Use of technology, such as big data/ alternative data analysis and deep learning
- ✓ Introduction of performance based fees
- ✓ Strengthening the comprehensive investment solutions business to construct and manage customized portfolios for clients (e.g., outsourced CIO)
- ✓ Selling advanced operational and risk management systems to other companies
- ✓ Raising revenue from asset administration services by expanding assets under administration

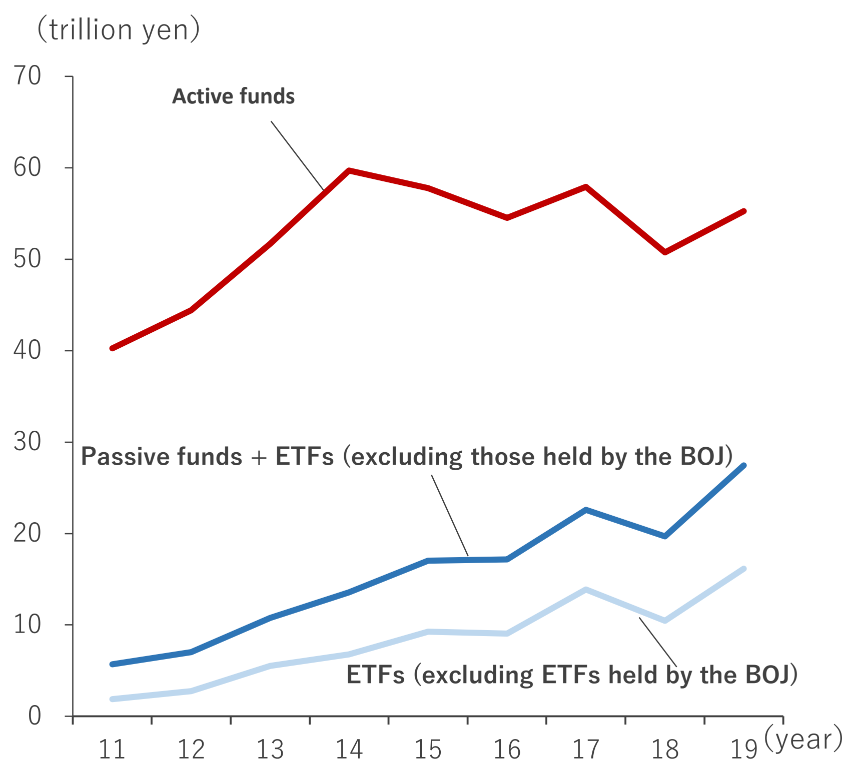
(Source) Prepared by the FSA based on interviews with the companies.

I. Current Status and Issues 1. Environment surrounding the asset management business - global perspectives

(3) Asset management business in Japan

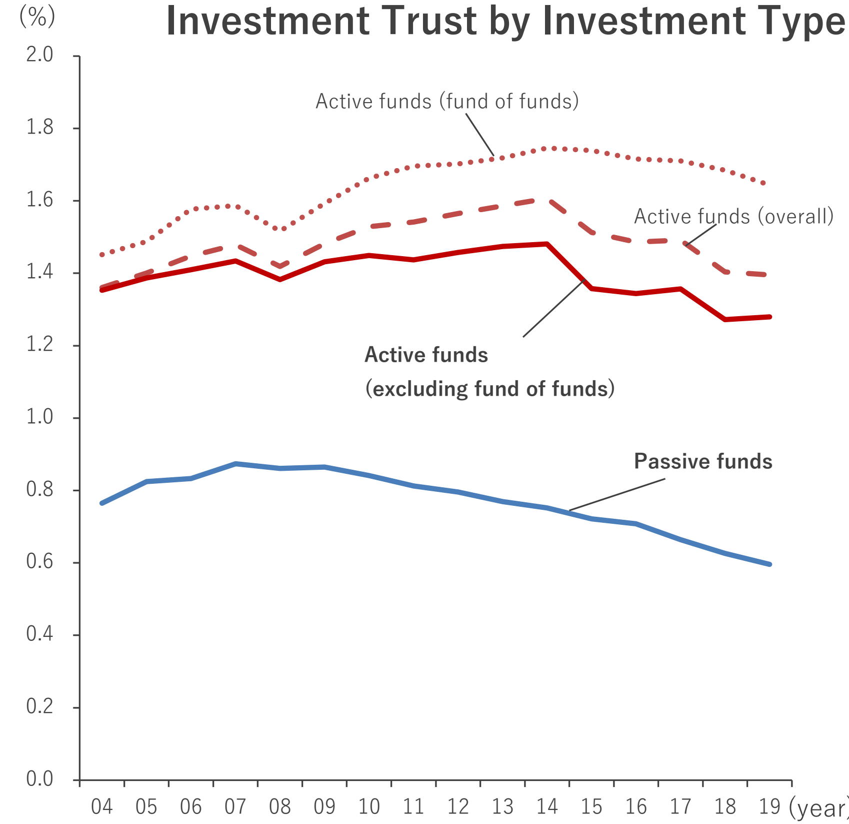
- Passive investment trusts (passive mutual funds) and ETFs in Japan are growing in terms of AUM and as a percentage proportion to all fund categories. However, the capital inflow into these categories is not as large scale as in the US. (Figure A)
- Trust fees (management fees) for active funds are declining similarly to passive funds. However, this decline has been rather moderate because of the increase in investment trusts of "fund of funds" type vehicle, which mainly consists of overseas sub-funds, as they usually carry higher management fees. (Figure B)
- In an increasingly competitive global environment, domestic asset management companies are facing intensifying competition.

A. Balance of Public Investment Trusts by Investment Type



(Note) The above data is based on public equity investment trusts. Bank of Japan holdings are calculated on a market value basis.
(Source) The Investment Trusts Association, Japan, and Bank of Japan

B. Trust Fees of Publicly Offered Investment Trust by Investment Type

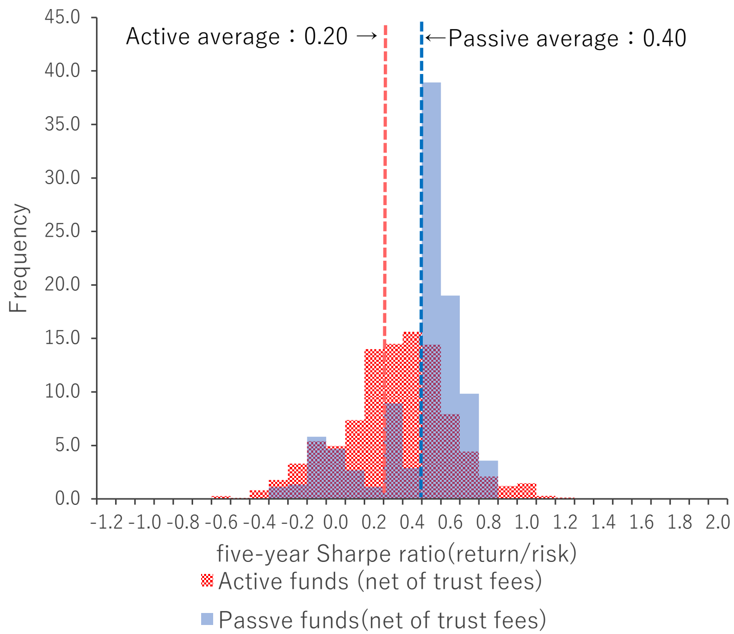


(Note) Each fund's trust fee is calculated on a weighted average basis using net asset values
(Source) QUICK

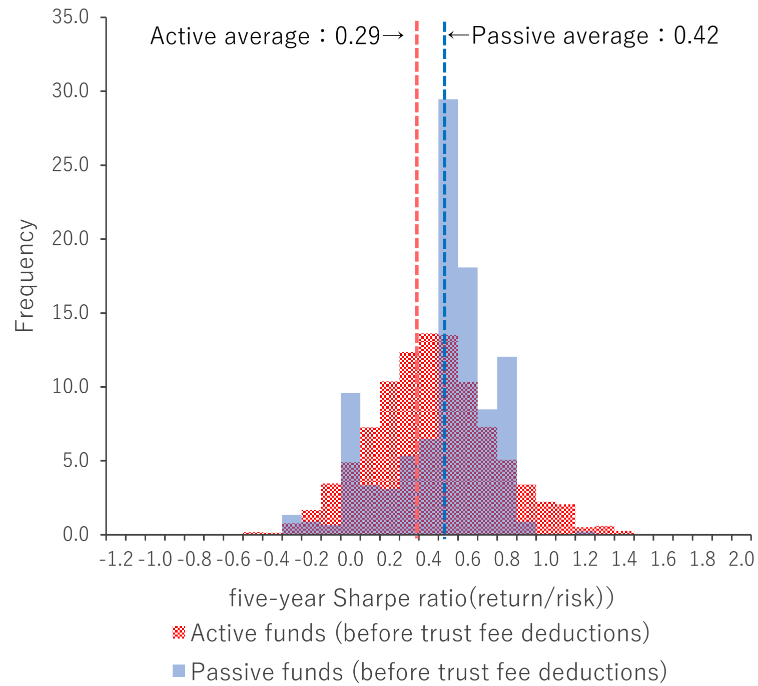
(1) Challenges faced by active investment trusts in terms of dismal performance

- While asset management companies in Japan provide various types of investment products, "publicly offered investment trusts" are especially important as financial products used for household asset accumulation. The FSA's analysis of publicly offered investment trusts illustrates that active funds underperformed on a risk-adjusted basis than passive funds on an overall basis, i.e., active funds on average posted 0.20, while passive funds posted 0.40 based on the Sharpe ratio net of trust fees basis for the past five years. (Figure A)
- Active funds underperformed passive funds even on the Sharpe ratio gross of trust fees basis, i.e., active funds on average posted 0.29, while passive funds posted 0.42. In addition to a risk-adjusted total performance comparison, Japan's active funds have also failed to deliver excess returns above the market average. (Figure B)
- Some of the observations worth mentioning are as follows: (a) the top-performing funds over the past five years were primarily active funds managed by independent asset managers (non-subsidiary of major financial conglomerate), and (b) some of active funds managed by large domestic asset managers also achieved favorable medium and long-term performances.

A. Sharpe Ratio (Net of Trust Fees)



B. Sharpe Ratio (Gross of Trust Fees)



(Note) Based on publicly offered investment trusts as of December 31, 2019 (excluding ETFs, and others.). Calculated as a weighted average of the five-year Sharpe ratio of each fund, excluding those with a standard deviation of 3σ or more. The Investment Trusts Association of Japan has defined "passive asset management" as "index-type asset management" in its product category. Trust fees are as of December 31, 2019.
(Source) QUICK

- Please note that a simple comparison between Japan's publicly offered investment trusts and US mutual funds is tricky because of differences in market conditions and AUM size. However, notably, the absolute level performance measured in terms of five-year average Sharpe ratios and cumulative returns of US mutual funds is distinctive.
- Active funds underperformed passive funds in all asset categories in terms of five-year average Sharpe ratios and cumulative returns both in Japan and the US. However, performance gap between active and passive funds is larger in Japan than in the US.
- Examining the break-down in Japan, the performances of active funds of domestic equity investment are relatively close to those of corresponding passive funds, while the active/passive performance gap is larger in advanced-countries/global equity investments.

A. Performance of Japanese Publicly Offered Investment Trusts

	five-year average Sharpe ratio	five-year cumulative return average (%)	Average expense ratio (%)	Number of funds	Net assets at the beginning of the period (100 million yen)
All funds(Passive funds)	0.40	22.60	0.44	450	66,366
All funds (Active funds)	0.20	9.70	1.49	3,029	555,260
Domestic equities (Passive funds)	0.50	40.00	0.49	131	20,670
Domestic equities (Active funds)	0.40	30.90	1.57	526	60,686
Developed market equities (Passive funds)	0.47	37.00	0.38	63	7,747
Developed market equities (Active funds)	0.23	12.00	1.79	415	76,969
Emerging market equities (Passive funds)	0.24	15.20	0.54	22	751
Emerging market equities (Active funds)	0.20	12.80	1.96	220	24,766
Global equities (Passive funds)	0.44	32.60	0.26	2	47
Global equities (Active funds)	0.17	8.20	1.78	34	12,014

B. Performance of US Mutual Funds

Category	five-year average Sharpe ratio	five-year cumulative return average (%)	Average expense ratio (%)	Number of funds	Net assets at the beginning of the period (USD 100MM)
All funds (Passive funds)	0.71	53.13	0.18	318	2,191,439
All funds (Active funds)	0.67	40.63	0.70	5,690	10,842,714
Equities(Passive funds)	0.73	60.97	0.18	202	1,803,657
Equities(Active funds)	0.64	54.54	0.82	2,804	5,662,731

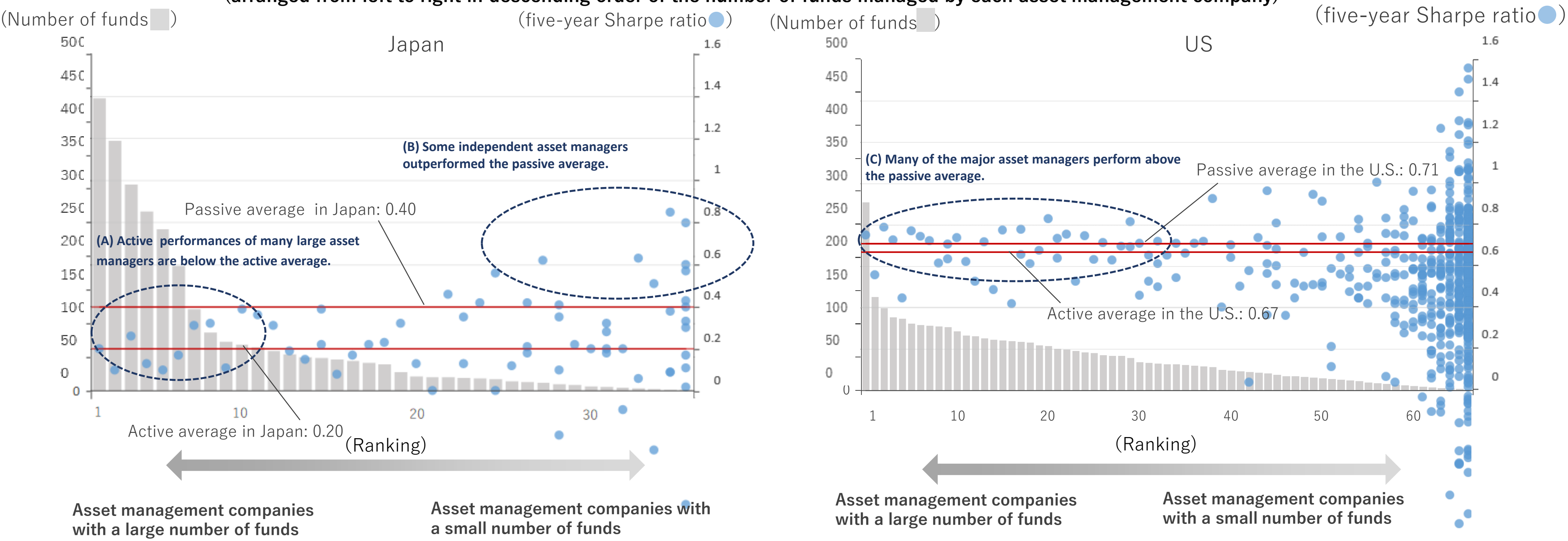
(cf.) Five-year average inflation rate: Japan 0.52%, US 1.55%

(Note) Data based on domestic publicly offered investment trusts in Japan and mutual funds in the U.S. (as of December 31, 2019 in both Japan and the U.S., excluding ETFs and others). The five-year Sharpe ratio of each fund is measured as asset-weighted averages.
Expense ratio is the ratio of management fees and other expenses to the asset balance of the investment trust. The Japanese expense ratio includes real (actual) trust fees, while the U.S. expense ratio includes real (actual) trust fees, audit fees, and transfer agent fees for back-office operations. Calculation is based on the balance-weighted average of each fund's exposure ratio. Note that foreign equity funds in Japan are denominated in yen, so that they tend to be affected by exchange rate fluctuations as a whole, although there are some currency hedges available.
(Source) QUICK, Morningstar

(2) Comparison with US mutual funds (b) Comparison by the number of funds managed

- The left figure below illustrates the performance comparison of Japanese publicly offered investment trusts, classified based on the number of funds managed by each asset manager. Performance itself is measured by five-year Sharpe ratios. The region labeled as (A) in the figure represents funds managed by major domestic asset managers. It implies that those funds underperformed not only the passive average (0.40) but also the active average (0.20). Meanwhile, funds in region (B), which outperformed not only the active average but also the passive average are primarily managed by independent asset managers with smaller number of funds.
- However, this is not the case in the US, i.e., even major managers with a large number of funds exceed the passive average (0.71), as shown in region (C) illustrated on the right figure.
- One reason for the underperformance of Japan's active funds on average is attributed to the oversupply of small-size funds that tend to deliver weak performance, which is further discussed later in this report.

Number and Performance of Active Funds Managed by Japanese and U.S. Asset Management Companies
(arranged from left to right in descending order of the number of funds managed by each asset management company)



(Note) Domestic publicly offered investment trusts in Japan and mutual funds in the U.S. (as of December 31, 2019 in both Japan and the U.S., excluding ETFs and others). The five-year Sharpe ratio of each fund is measured as asset-weighted averages.
(Source) QUICK, Morningstar

(3) Performance of major domestic asset managers (a) Domestic asset classes

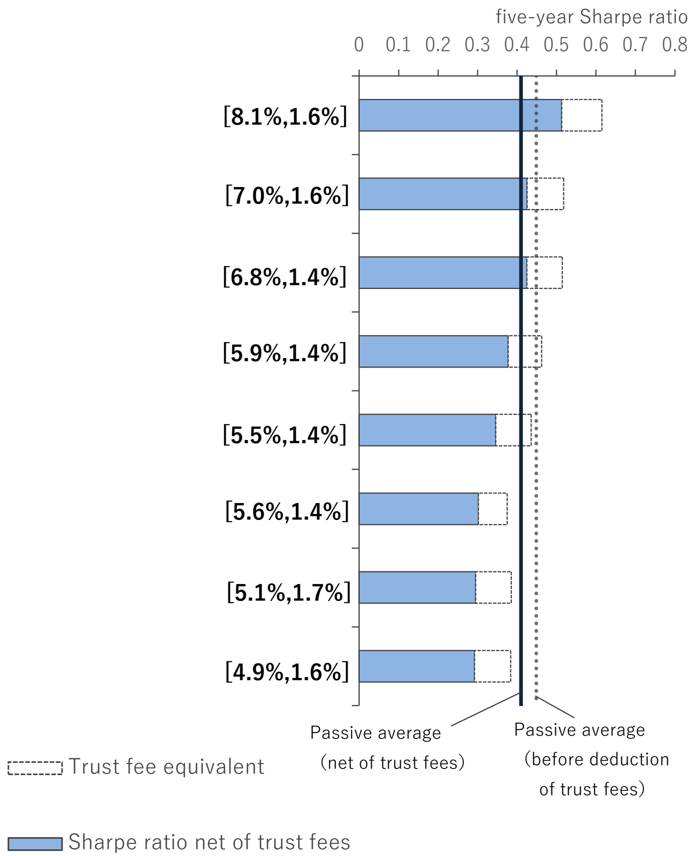
- Active domestic equity funds of eight major domestic asset management companies achieved almost equivalent performances with corresponding passive funds measured by the Sharpe ratio with the past five years data net of trust fees. (Figure A)

- Active domestic fixed income funds in general underperformed passive equivalents on a net-of-fee basis due to higher trust fees than those of the passive funds. (Figure B)

* Please note that domestic fixed income funds tend to produce higher Sharpe ratios with net-of-fees basis, as fixed income funds carry relatively lower risk than domestic equity funds, i.e., the risk number is the denominator while the return number is the numerator in the Sharpe ratio calculation.

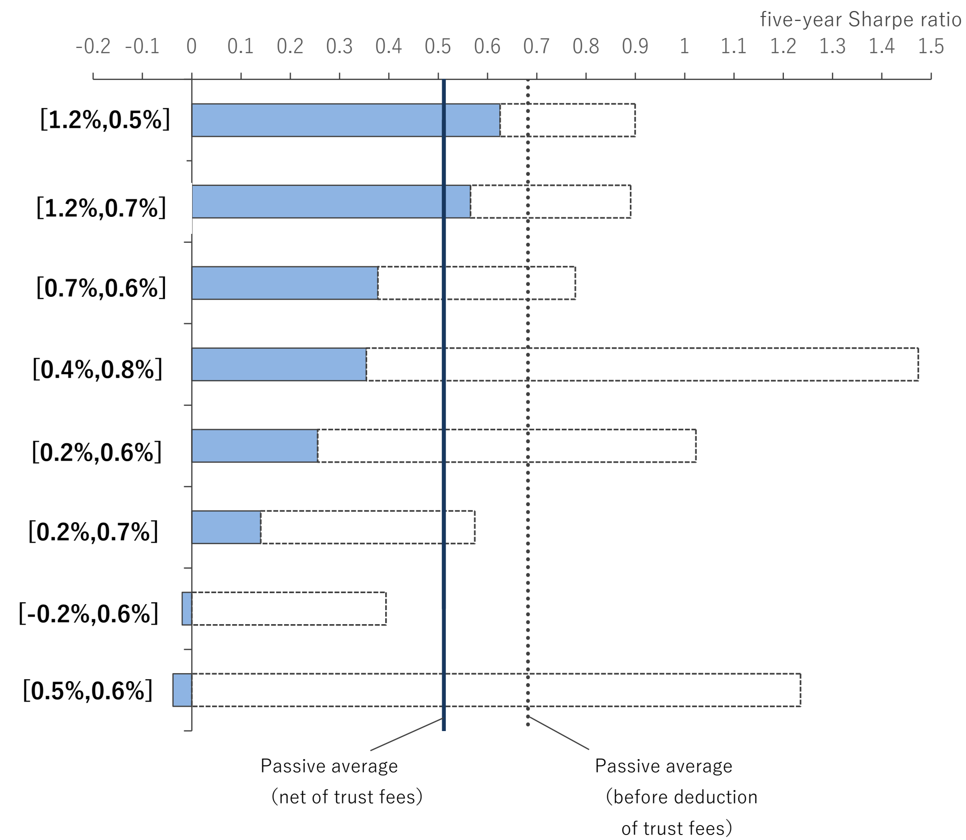
A. Domestic equity funds

[Annualized return, real (actual) trust fees]



B. Domestic fixed income funds

[Annualized return, real (actual) trust fees]



(Note) Based on publicly offered investment trusts in Japan as of December 31, 2019 (excluding ETFs and others). Measured by simply averaging the five-year Sharpe ratio of each individual investment trusts. Asset classes are based on the product classification of the Mutual Fund Association. The Mutual Fund Association's product classification of "index-type" is deemed equivalent to "passive investment trusts." Trust fees are as of December 31, 2019. Sharpe ratio before trust fees is an estimate calculated by adding real (actual) trust fees to annualized returns and dividing by risk (standard deviation). Note that the risk is an annualized value calculated based on returns after deductions, not before the deduction of trust fees.

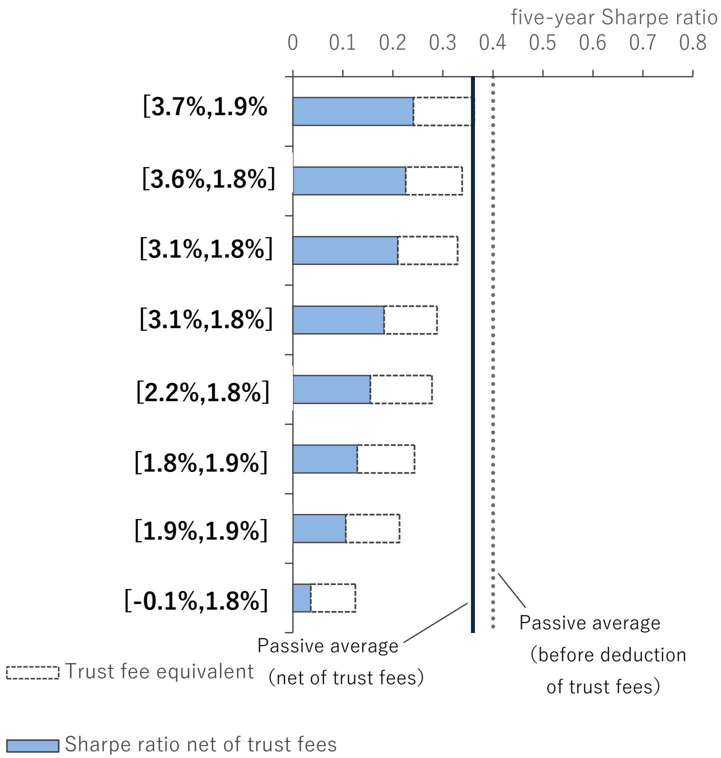
(Source) QUICK

(3) Performance of major domestic asset managers (b) Overseas asset classes

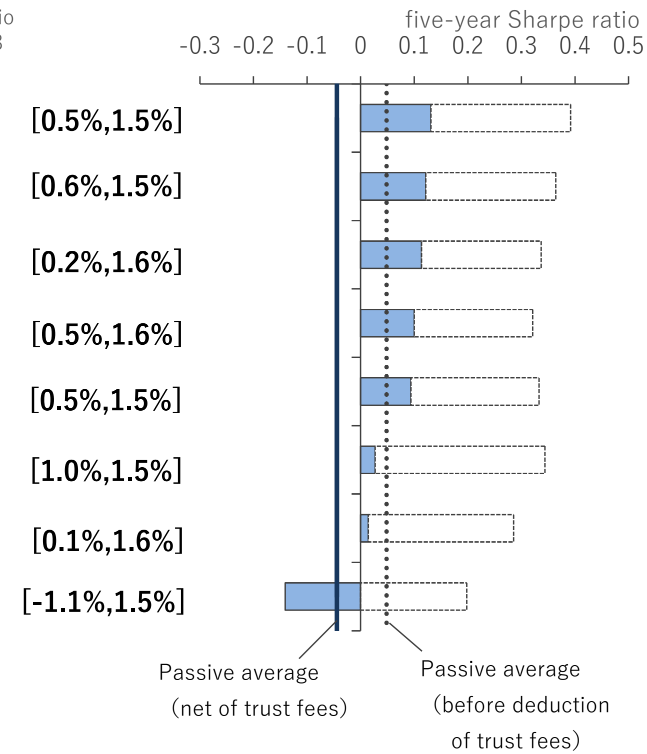
- Active foreign equity funds and mixed-asset funds containing foreign assets underperformed the corresponding passive funds even before trust fees basis. (Figures A and C)
- Active foreign fixed income funds outperformed the corresponding passive funds both on before fees and net fees basis.(Figure B)

  * Please note that most of the passive foreign fixed income funds have been indexed to the developed sovereign bonds (investment grade). This structure resulted in relatively high NAVs (net asset value per share of unit trust) of those funds at the beginning of the calculation period of the past five years when significant depreciation of JPY against developed market currencies occurred due to Japan's easing monetary policy implemented in October 2014. Therefore, the following five years of these funds carried relatively low performances due to this relatively overvalued beginning NAVs. On the other hand, active fixed income funds tended to achieve favorable performance because of their credit-sector investments in emerging sovereign bonds and non-investment grade bonds of developed countries.
- Asset management companies acknowledge that there is room to improve their in-house investment capacity to achieve adequate performance commensurate with the level of trust fees, as well as their ability to distinguish competent external managers.

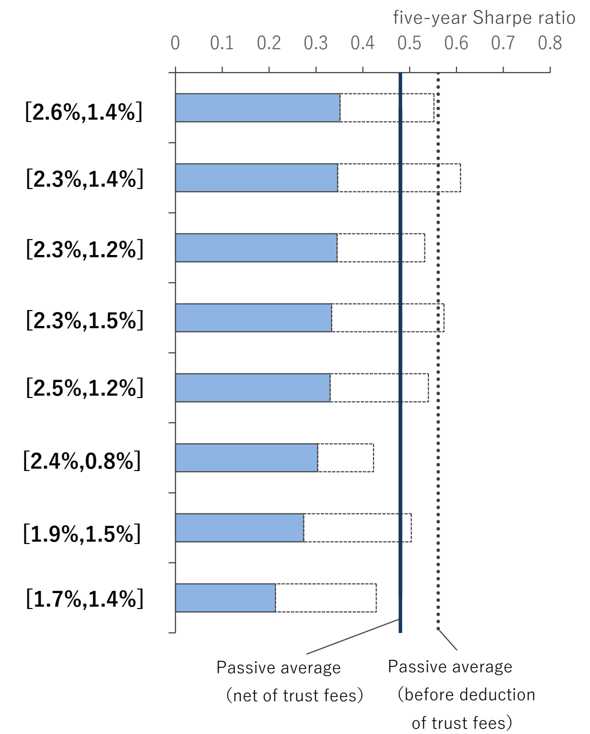
A. Foreign equity
[Annualized return, real (actual) trust fees]



B. Foreign bond
[Annualized return, real (actual) trust fees]



C. Asset mix
[Annualized return, real (actual) trust fees]

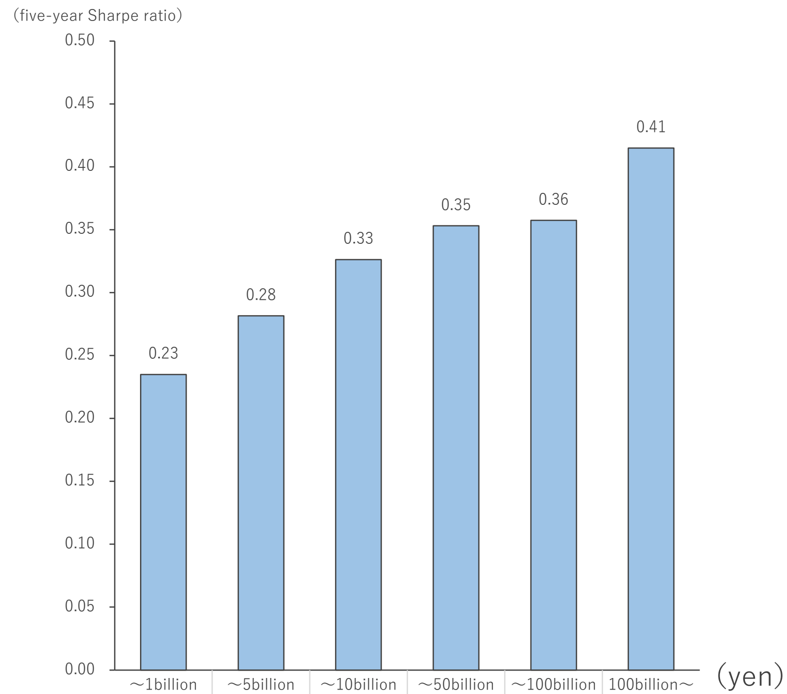


(Note) Domestic public investment trusts as of December 31, 2019 (excluding ETFs and others). Measured by simply averaging the five-year Sharpe ratio of each fund for each individual asset management companies. Asset classes are based on the product classifications of the Mutual Fund Association. "Index-type" of the product category of the Investment Trusts Association, Japan is defined equivalent to "passive investment funds." Trust fees are as of December 31, 20. The Sharpe ratio gross of trust fees is an estimate calculated by adding real (actual) trust fees to annualized returns and dividing by risk (standard deviation). Note that the risk is an annualized value calculated based on returns after deductions, not before the deduction of trust fees.

(Source) QUICK

- Five-year Sharpe ratio shows positive relation with fund size, i.e., the bigger the fund, the higher the Sharpe ratio. (Figure A).
- The number of small size funds with AUM under five billion JPY (USD 50 million equivalent) is quite large in Japan, and many funds with AUM even under one billion JPY (USD 10 million equivalent) exist. Besides this overall picture, it is possible that many of these small-sized funds cannot earn enough fee income to cover their management costs when analyzing fund-by-fund basis. Suppose this is the case, these excess costs, if any, would be ultimately born by the clients of other funds managed by the same asset manager. (Figure B)

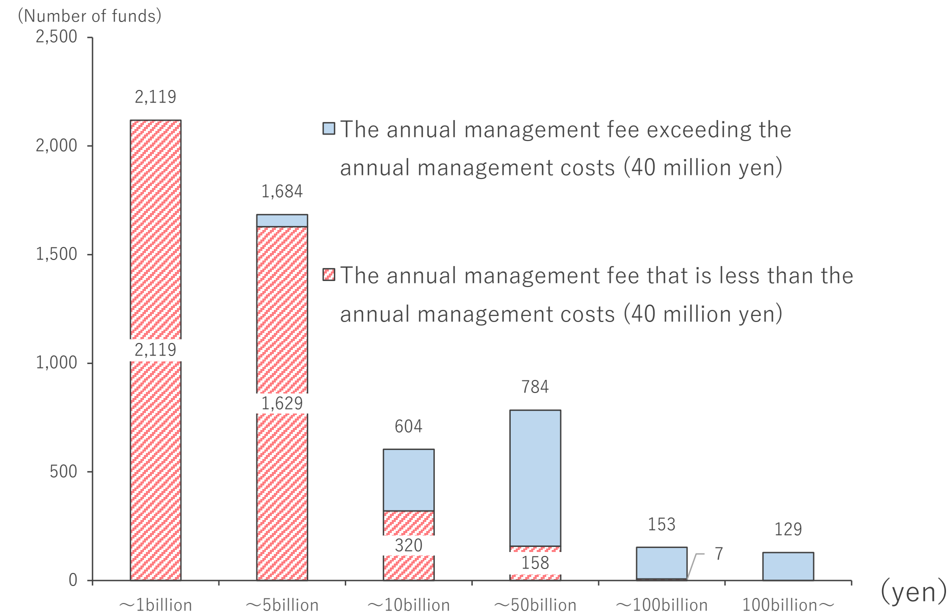
A. Performance by fund size



	〜1billion	〜5billion	〜10billion	〜50billion	〜100billion	100billion〜
Percentage of total net assets of publicly offered investment trusts	0.9%	6.0%	6.2%	24.3%	18.0%	44.5%

(Note) Based on publicly offered investment trusts in Japan as of December 31, 2019 (excluding ETFs and others). Measured by weighting the five-year Sharpe ratio of each fund by net asset value.
(Source) QUICK

B. Number of investment trusts and profitability by fund size



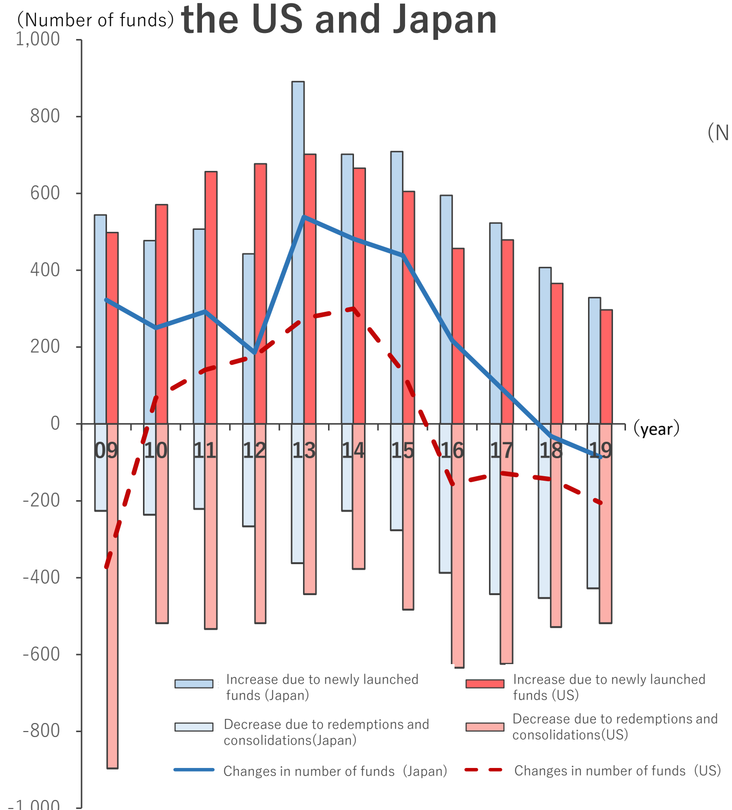
(Note) Domestic publicly offered investment trusts as of December 31, 2019 (excluding ETFs, and others). Annual operating costs (40 million yen) are based on the median of annual operating cost per fund (approximately 42.4 million yen), which are set out on the Nomura Research Institute's "Benchmarking Survey of Asset Management Companies" (fiscal 2009) (provisional English title).
(Source) QUICK, and Nomura Research Institute

I. Current Status and Issues 2. Market landscape of publicly offered investment trusts in Japan

(4) Too many small-sized investment trusts (b) Comparison with the US

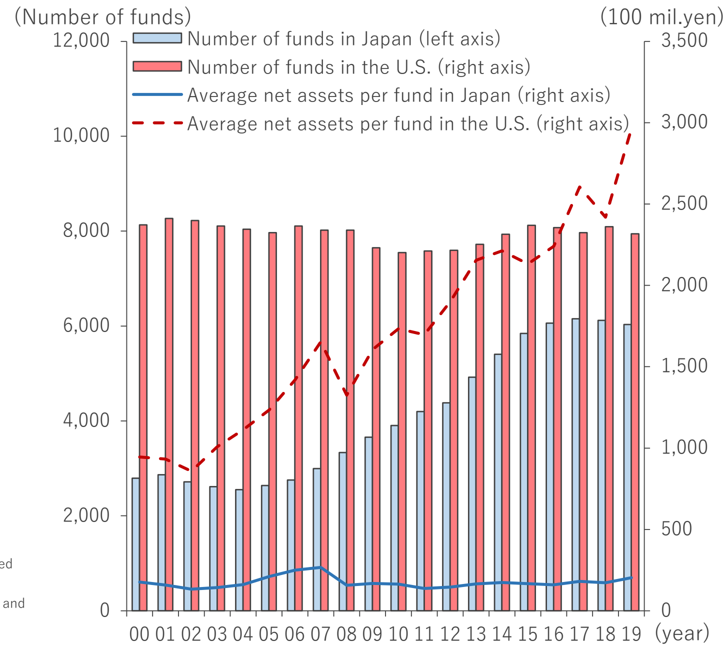
- The number of funds launched in Japan is on a downward trend but continues to show higher numbers than new launches in the US.(Figure A) Japan's asset management companies are said to have focused on developing new products to earn commission income rather than increasing the AUM of existing funds.
- The total number of outstanding funds in Japan has recently begun to decline but still remains at an extremely high level. The growth in AUM per fund in Japan has been sluggish, partly because the US trend in which passive funds grow larger due to massive capital inflows has not been observed in Japan so far. (Figure B)
- Asset management companies with a large number of funds tend to offer many small-size funds with AUM under JPY one billion or USD 10 million equivalent. (Figure C).
- Redemptions and consolidation of funds have not made sufficient progress in Japan partly due to burdensome procedures. However, the first case of consolidation was completed in May 2020, and succeeding cases are expected. Asset management companies need to cooperate with distributors to proactively redeem or consolidate small size funds that do not benefit their customers, such as unprofitable funds that hardly covers their own costs and funds with poor medium to long-term performance.

A. Funds launched and redeemed in the US and Japan



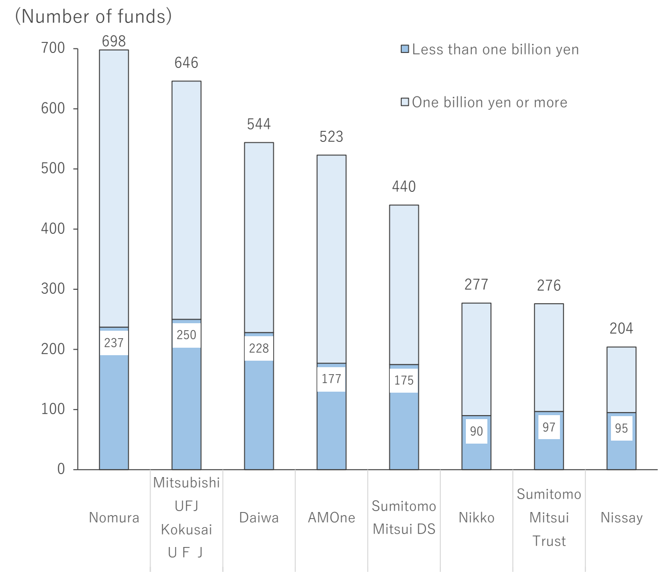
(Note) The Japanese figures reflect the number of publicly offered investment trusts and those of the U.S. reflect the number of mutual funds.
(Source)The Investment Trusts Association, Japan, Investment Company Institute

B. Changes in the number of funds and balances per fund in the United States and Japan



(Note)The Japanese figures reflect the number of public investment trusts and those of the U.S. reflect the number of mutual funds.。
(Source)The Investment Trusts Association, Japan, Investment Company Institute

C. Asset managers with a large number of funds and funds under one billion USD

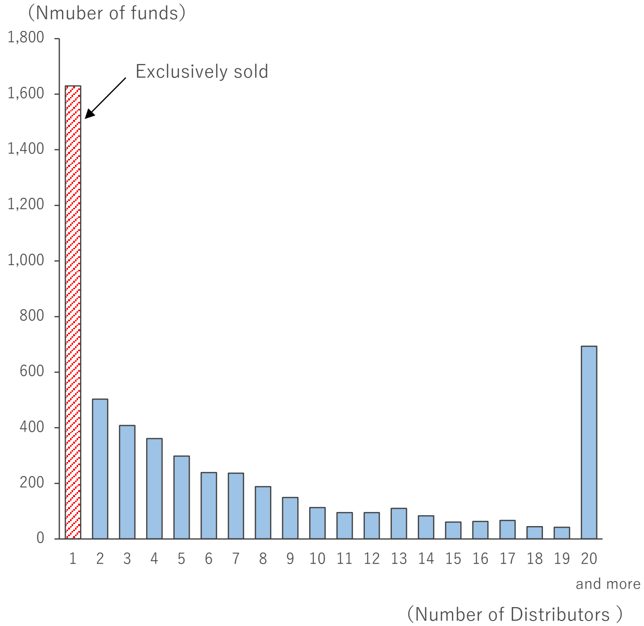


(Note) Domestic publicly offered investment trusts as of December 31, 2007 (excluding ETFs and others).
(Source) QUICK, Japan Investment Advisors Association

(4) Too many small-sized investment trusts (c) Exclusive sales by company group distributors and fund size

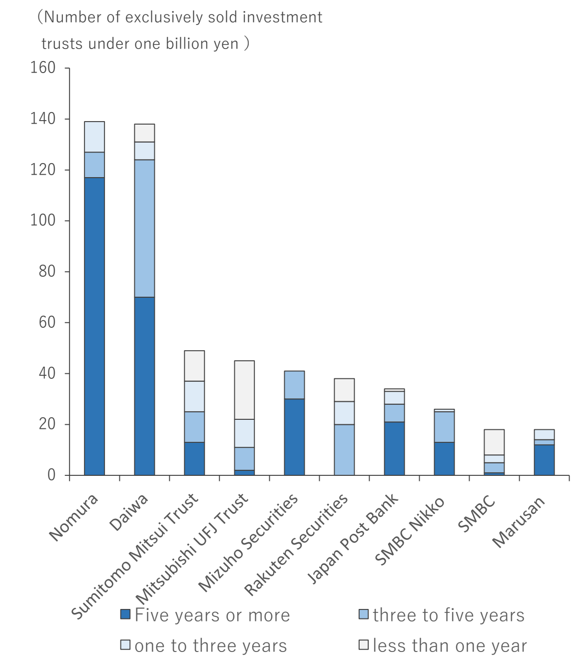
- The oversupply of small-sized funds could be partly attributed to the business practice of exclusive distributorship, which limits the asset management companies' distribution of new products for a certain period of time (6 months to 1 year after fund launch). Approximately 30% of the total number of outstanding funds followed this exclusive distributorship practice. (Figure A)
- Distributors with a large number of exclusively sold funds tend to maintain such exclusive distributorship for long period of time. (Figure B)
- Approximately 30-40% of the two- to five-year old funds have been kept "under exclusive distributorship," which may have hampered the expansion of distribution channels and keeping the fund sizes small. (Figure C) Owing to limited distribution channels, some funds, even high-performing ones, fail to attract capital inflows and secure sufficiently large total AUM for efficient investment management. (Figure D)
- There are various reasons for maintaining an exclusive distributorship practice. This practice could be beneficial to customers in some cases while it could cause the oversupply of small size funds. Limited distribution channels could also result in production and non-elimination of small size funds, which might not provide value to customers. To avoid these circumstances, it is necessary for asset managers, in cooperation with distributors, to structure products that could achieve favorable medium and long-term performance, and to streamline existing funds by redeeming and/or consolidating small size funds.

A. Number of distributors and total number of investment trusts



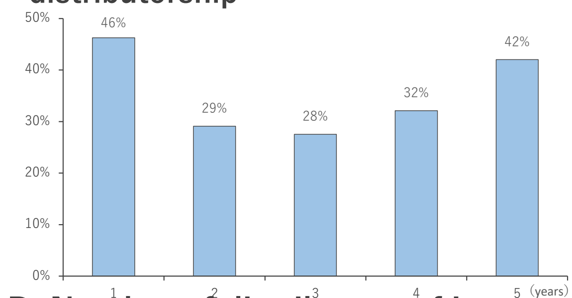
(Note) Domestic publicly offered investment trusts as of December 31, 2019 (excluding ETFs and others).
(Source) QUICK

B. Distributors with a large number of exclusively sold investment trusts under one billion yen

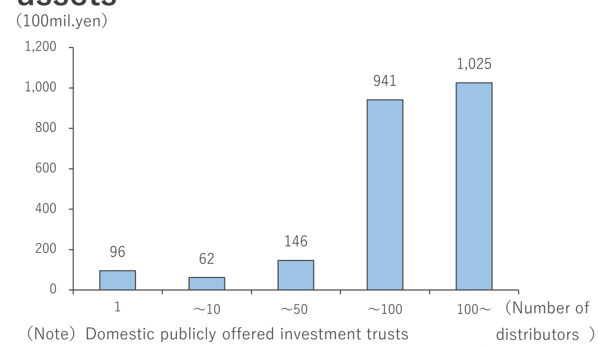


(Note) Domestic publicly offered investment trusts as of December 31, 2019 (excluding ETFs and others).
(Source) QUICK

C. Number of years since the launch of investment trusts and rate of exclusive distributorship



D. Number of distributors of investment trusts and those average total net assets



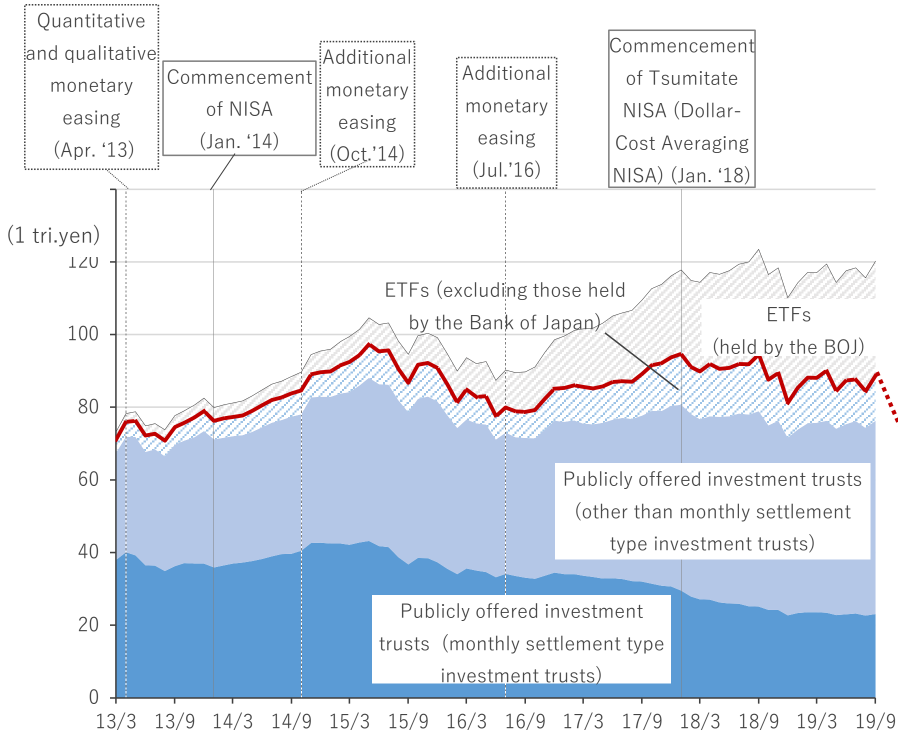
(Note) Domestic publicly offered investment trusts as of December 31, 2019 (excluding ETFs and others).
(Source) QUICK

2. Market landscape of publicly offered investment trusts in Japan

(5) AUM trend

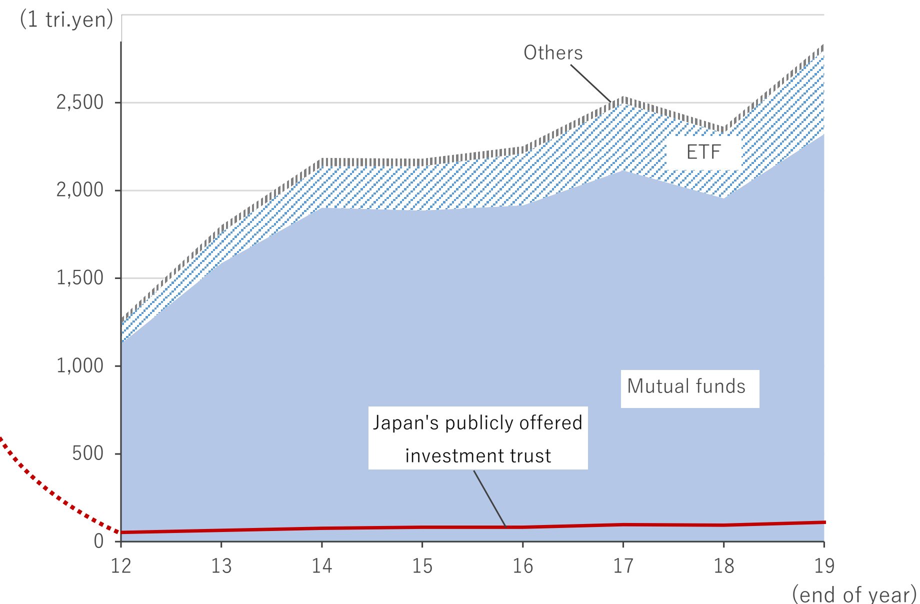
- The AUM of Japan's publicly offered investment trusts, excluding the ETFs held by the Bank of Japan, have remained flat for years, despite the stock market having been relatively bullish. (Figure A)
- Compared to the total net assets of US investment companies, the balance in Japan's market is still less than one-twentieth the scale of the US market, even including the ETFs held by the Bank of Japan. (Figure B)

A. AUM of Japan's Publicly offered Investment Trust



(Note) ETFs (held by the Bank of Japan) reflect their value of ETFs (market value basis, aggregated semi-annually).
(Source) The Investment Trusts Association, Japan, the Bank of Japan, and the FSA

B. AUM of US mutual funds



(Note) Based on exchange rate at each year end
(Source) Invest Company Institute

II. Key challenges 1. Organizational Governance
(1) Practicing supervisory function from the perspective of prioritizing customers' interests

- Japanese asset managers are expected to solidify company revenue bases by gaining the credibility and favor of their customers by achieving favorable medium to long-term performance under intensifying competition. To this end, they need to improve (enhance) their managerial/operational structures by establishing a governance structure and corporate culture, which prioritizes customer interests and values of long-term investment, clarifying corporate vision and core competence, and making efforts to implement such vision and competence.
- From the "governance" standpoint, the majority of Japanese publicly offered investment funds are contractual-type funds, unlike mutual funds in the US, which are mostly corporation-type. While a corporation-type fund has an independent governing body, which solely fulfils the fiduciary duty responsibilities for customers by supervising the asset management practice, this is not the case for contractual-type funds in Japan. Correspondingly, the board of directors of asset management companies need to play a core role in ensuring customer interests. This customers'-interest first governance establishment is especially imperative for asset managers that are part of a financial conglomerate because their decisions might possibly be influenced by the parent company's interest.
- Major domestic asset management companies have begun enhancing fund governance functions such as establishing fund governance committees, by including independent (outside) directors. Although such efforts are making some progress, these committees do not have formal legal obligations to customers, unlike the fiduciary duty stipulated under US law, and the ultimate authoritative power of such committees over the asset management practice is very limited. This poses challenges in ensuring to the committee's effective supervision functions through analysis and management in terms of profitability and expense level on individual funds.

	US	UK	Japan
Major forms of funds	Corporation type	Contractual type/Corporation type	Contractual type
Institution responsible for governance	Fund's Board of Directors (BoD) Investment advisor's BoD	Authorized Fund Manager (AFM)'s BoD, in effect	Asset manager's BoD
Obligations to customers (investors)	Fund's directors and investment advisors owe a fiduciary duty	AFM owes a duty to act in the best interest of fund investors	Asset manager owes duty of care and loyalty (Article 42 of the "Financial Instruments of Exchange Act" (FIEA))
Obligation to have outside directors	• Fund's BoD: Majority of directors must be independent directors pursuant to the SEC rules • Investment advisor's BOD: Majority of directors must be independent directors if the company is listed on the NYSE	AFM's BoD must comprise at least 25% of the management company's board of directors and at least two independent directors	Under the Companies Act, only a company with a certain organizational structure is required to appoint outside directors *Under Japan's Corporate Governance Code, listed companies are required to appoint two or more outside directors.
Ownership structures of major asset managers	Ownership by founders, partnership, public listing, and ownership by the parent company (which values asset managers' independence)	Ownership by founders, partnership, and public listing	Ownership by the parent company

Box 1: Policy responses regarding the governance of asset management firms in the UK

- In the UK, the Financial Conduct Authority (FCA) noted that investors' benefit has not fully been secured because asset managers had not rigorously considered the "value" they offer to investors, and consequently, provided poor value products. This remark is based on the results of its Asset Management Market Study and the FCA supervisory works.
- Considering this, the FCA has implemented a series of policy measures, including regulatory reforms, in reference to the fund governance system in the US, by requesting asset managers to appoint two and at least 25% of the total number of directors to be independent directors, and to annually assess and disclose the "value for money" (VfM) for each fund. In this way, the FCA is promoting customers' interests by improving governance among asset managers.

Key policy measures taken by the UK FCA (contractual-type/corporation-type funds)

✓ **Requiring independent directors on asset manager (AFM) boards** [by September 30, 2019]: at least two and not less than 25% of the total

✓ **Value for money (VfM)assessment process** [since September 30 2019]
: Each AFM director is required to assess the following items, at least, **on an annual basis,** and disclose the results of the assessment to investors in an annual report or other format (and take **action** if the company is not providing good value for money)
(1) Range and quality of services
(2) Performance benchmarked against the fund's objectives
(3) VFM (value for money) assessment costs
(4) Economies of scale
(5) Market prevailing rates of comparable/equivalent funds
(6) Management fees for comparable products for other types of customers such as institutional investors
(7) Reasons why retaining investors in share classes where asset management fees are rather expensive

✓ Extending the **Senior Managers and Certification Regime** (SM&CR) to AFMs [since December 2019]
: The authorities have strengthened personal liability, including the obligation to conduct VfM assessments. The senior management team shall be approved for appointment by the FCA after determining their eligibility (fit and proper).

Fund governance framework in the US (corporation-type funds)

✓ **Appointment of independent directors of a fund:** 40% or more in principle (Section 10(a) of the Investment Company Act of 1940); **50% or more** under the SEC rules and regulations. An independent non-profit organization comprising mutual fund industry recommends 75% or more.

✓ **Evaluation and approval process for asset management contracts** (Section 15(c) of the Investment Company Act of 1940): The fund directors are required to assess and approve the investment management agreement annually as fiduciaries, and the approval of a majority of the independent directors is required thereto. The deciding factors underlying the approval and the results of the assessment must be included in the annual report. Items to be considered in the assessment are as follows; (assessment criteria as to whether or not the excessive fee constitutes a violation of the fiduciary duty under Section 36(b) of the Act):
(e.g. the 1982 Gartenberg Decision (Gartenberg Principles) and others)
(1) The nature and quality of the service (including performance)
(2) Profitability of the investment manager
(3) Economies of scale
(4) Expense ratios and fees for comparable/equivalent funds

➡ When noncompliant with fiduciary duties, an asset management company can be subject to civil litigation by the SEC and investors, as well as to inspections and administrative sanctions by the SEC.
(The SEC's OIEC Risk Alert, published in November 2019, identifies deficiencies such as (1) insufficient collection and consideration of information from asset management companies and (2) insufficient discussion on the basis of approval, thereby recommending improvements).

In January 2020, the FCA issued a letter to the CEOs of asset management companies (authorized fund managers), stating that the FCA would **check the governance and the effectiveness of their assessment process for value for money (VfM) in the first half of 2020**, and would ask for evidence on whether or not **the Board of Directors implement substantive supervision/control in response to the proposal from the corporate management team** in terms of costs, fees, and product design.

II. Key challenges 1. Organizational Governance

(2) Parent companies need to fully acknowledge key issues in the asset management business and extend cooperation

- Many of the major domestic asset management companies were founded as subsidiaries of product distributors within finance conglomerates and expected to play roles of providing products for their parent companies and/or distributors in each conglomerate. This organizational structure might have caused the insufficient independency of subsidiary asset managers. For example, the majority of board members of an asset management company tend to be appointed from the group's parent company rather than by recruiting asset management professionals from outside.

- Furthermore, the parent company and other constituent companies within the financial conglomerate tend to have an insufficient understanding of the asset management business, which should prioritize customers' interests. Not fully-incorporating customers' perspective might be the result of "prioritizing short-term company profit" business attitude. Accordingly, financial conglomerates have been said that they have failed to establish definitive strategies on how and in which directions they should guide their asset management arms to pursue their own corporate visions, and they might have lacked conscientious commitments to investment results.

- To improve the governance structure at an asset management company to prioritize customers' interests, it is indispensable that its parent company should fully understand the nature of the asset management business and provide necessary cooperation and commitment to achieve an advanced asset management practice.

Asset management company

Managerial principles and philosophy

✓ Corporate vision and core competence to pursue are not transparently set up.

✓ "Customer-first" mission is not fully practiced?

Managerial structure

✓ Top management with insufficient experience and understanding of the asset management business?

✓ Managerial structure is not best suited for pursuing long-term oriented perspectives.

Business operations

✓ Need to refurbish HR management structure and evaluation/remuneration structure to scout and retain competitive investment professionals, and employee training and development structure to build and enhance the capacity of internal HR resources as investment professionals.

✓ Inadequate operational management structure for developing customer-needs-oriented products and efficient management (dealing with small-sized funds and better handling of size-based investment management).

・HR (placement) decisions for senior management and key personnel
・Compensation structure is set up in a holistic manner across the conglomerate rather than reflecting the uniqueness of the asset management subsidiary business.

Insufficient understanding and cooperation within conglomerate/group companies

・Inclination to launching new products rather than refurbishing existing funds.
・Limitation of distribution channels due to exclusive sales practice.

Parent company

✓ Insufficient experience and understanding of the asset management business where customers' interests should be prioritized first

✓ Revenues (typically single fiscal year basis and AUM) are the main evaluating factors for the subsidiary business.

Affiliated distributors (retail sales companies)

✓ Commission-based business model and revenue evaluation (which prefers products that are easy to sell and earn commission)

✓ Distributor dominant power structure over asset management companies

Failing to provide customers with favorable medium to long-term performance

Ⅱ Key challenges 2. Managerial/Operational structure

Establishing a managerial/operational structure that can prioritize customers' interests and values of long-term investment (a)

- Asset management companies are required to undertake sound and robust investment operations for their customers' benefit. For this, they need to establish appropriate managerial/operational structures that enable resilient organizational and fund management by emphasizing the value of long-term oriented perspectives.
- Some key findings from the interviews with several overseas asset managers conducted by the FSA last year include distinctive examples as follows; (i) senior management, including the top manager, consists of personnel with long experience in the asset management business and they are retained for long periods, i.e., this HR treatment appears to be a good practice to implement and attain management (and investment) based on long-term oriented perspectives, and (ii) HR decisions on senior management in asset management maintain independence within the umbrella financial conglomerate.
- In Japan, there are, of course, good examples that some of the major asset managers are aware of the problems and are working to reform their management structures. However, other cases indicate that the traditional HR treatment still prevails, i.e., personnel with little experience and understanding about asset management business are placed as senior managers under the traditional HR job rotation system within the intra-company-group (conglomerate), and there are cases of such job rotation in periodic short-term cycles. In the end, there is much room in terms of establishing a managerial/operational structure that can prioritize customers' interests and values of long-term investment.

Practices/initiatives by foreign asset management companies

■ Long tenures of 20 years or more given to senior management with experience in the asset management business

- The founder of BlackRock (U.S.), with 32-year history since inauguration, has been serving as the Chairman and maintained a consistent corporate culture.
- PICTET (Switzerland), which is privately owned by partners, continues to operate based on a long-term perspective, with the average tenure of partners (excluding the incumbents) being approximately 21 years.
- The current president of T. Rowe Price (U.S.) has been with the firm for more than 30 years with a working career as an analyst and fund manager. He has also served as a director in the head office for more than 10 years.

■ As a result of long-term management, many funds have shown outstanding performance for more than 30 years and have grown in scale.

- Capital Group (U.S.) "New Perspective Fund" was launched in 1973 (47-year-old fund), and its AUM is approximately 11 trillion yen.
- T.Rowe Price "Growth Stock Fund (domiciled in US)" was launched in 1950 (70-year-old fund), and its AUM is approximately 10 trillion yen

■ Asset management companies owned by financial conglomerates ensure the independence of each department by not regularly exchanging officers and employees with the parent company or other business units (e.g., banks and brokers) within the group.

Practices observed through monitoring by the FSA

- The JFSA observes some notable examples of financial conglomerates embarking on efforts to implement a long-term oriented business strategy, aware of the importance of an in-depth understanding and commitment to their asset management business and respecting the independency of asset management subsidiaries. Such mindsets are indispensable for firm progress in terms of enhancing the asset management business. One such example is an asset management company undertaking structural reform by bringing outside professionals with long experience of the asset management business into the center of the managerial structure, which means growing out of conventional HR practices of intra-conglomerate-group job rotation. In contrast, another example indicates that an asset management company appoints internal professionals with long experience in the asset management business as key top managers of an asset management subsidiary from other parts within the conglomerate, such that they can leverage the conglomerate's core competence to enhance its asset management arm as a core business.

  - Sumitomo Mitsui DS Asset Management Company, Limited has invited a person well-versed in the asset management business from outside the group, and appointed as the President and the CEO; whereas Sumitomo Mitsui Financial Group, Inc. has similarly appointed an experienced person from outside the Group to its Board of Directors who is in charge of its asset management business.

  - Mitsubishi UFJ Financial Group, Inc. has made its asset management subsidiaries such as Mitsubishi UFJ Kokusai Asset Management Co., Ltd. and MU Investments Co., Ltd. wholly owned subsidiaries of Mitsubishi UFJ Trust and Banking Corporation, and clarified that it will promote the asset management business of the entire group by placing Mitsubishi UFJ Trust and Banking Corporation in the core of the group's asset management business, focusing on mutual independence.
  - The Nippon Life Group emphasizes that it continues to strengthen the asset management business backed by the entire Group by leveraging its portfolio management expertise accumulated through the balance sheet management of its life insurance business over the years to be utilized at its asset management subsidiary, Nissay Asset Management Corporation.

- Meanwhile, other cases indicate insufficient achievements in terms of implementing a long-term vision oriented management style and maintaining independency as an asset manager, despite trying to emphasize the importance of the asset management business by placing experienced internal professions in that area as the top management of a subsidiary asset company. It is assumed because the influence of the parent company and/or conglomerate group companies is still too strong over the asset management subsidiaries. Other cases also indicate that old-fashioned HR practices are still maintained, i.e., personnel with insufficient experience and expertise of investment business are mechanically appointed as senior management as per the parent company-led conventional intra-group job rotation practice.

- Although the respective leading asset management companies have appointed outside directors, only a few of them have appointed independent outside directors well versed in the asset management business.

  - Nikko Asset Management Co., Ltd. appointed seven independent outside directors out of ten board members, a relative majority of the entire board of directors, whereas four of the seven independent outside directors have been in the asset management business for years.

3 . Corporate vision and core competence: Clarifying corporate vision and core competence as an asset manager and making efforts to implement this vision and core competence (a)

- Asset managers are expected to achieve robust and consistent performance in the medium to long term for their customers, and consequently, to maintain resilient business management. Therefore, it is important for them to clarify their corporate vision and core competence and take resolute actions to implement them.
- Some good examples are overseas asset managers that clearly define their core competence taking into account the surrounding external environment, formulate practical strategies to implement the corporate vision and goals, and actually implement them in practice.
- Examining at the past five year performance of domestic publicly offered investment trusts, we also found that many of the top ranked names include independent asset managers with clearly defined corporate visions and core competences.
- However, some of the major asset management companies in Japan do not necessarily have a clearly defined corporate vision, goals, and core competence, and consequently, they lack sufficient strategic plans to implement their vision and core competence.

Examples of overseas asset management companies

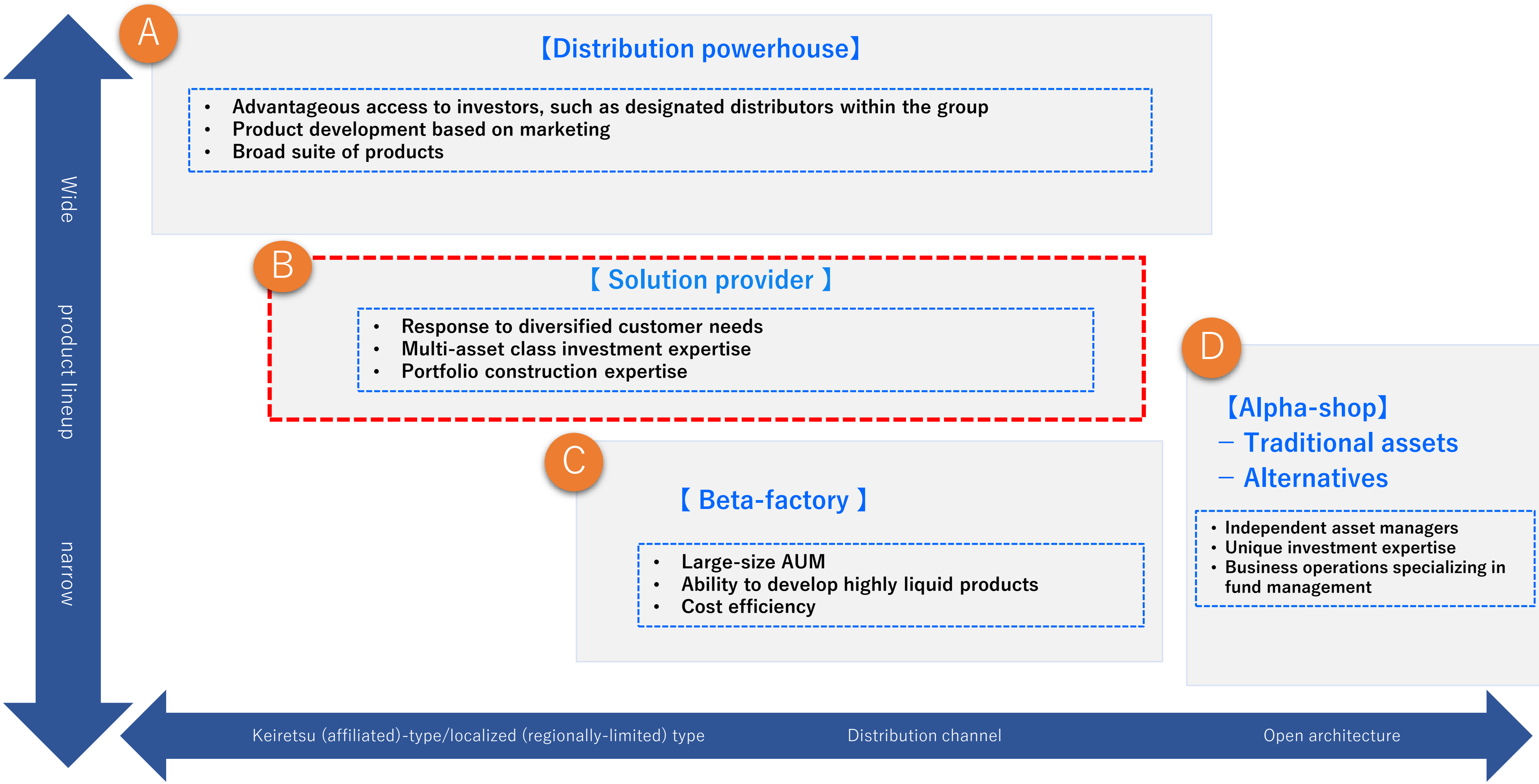
- ■ Corporate philosophies such as "Generating excess return (alpha)," "Long-term investment with the highest priority on client profit," "Minimizing costs for client profit" result in clarification of the company's core competence to implement those philosophies of specializing in active investment, focusing on alternative investment, and establishing robust investment management through advanced risk management techniques.
  - Independent active managers such as Capital Group and T.Rowe Price focus on generating alpha (excess return) through long-term investments based on original research by internal analysts.
  - Nuveen (U.S.) has established alternative investments as one of the company's specialties to facilitate long-term stable investment for its parent company, which is also the asset owner. Nuveen focuses on non-traditional assets such as real estate, farmland, forests, and commodities, and increased the percentage of alternative assets to approximately 25% of its total asset under management.
  - BlackRock strongly emphasizes risk management, with approximately 270 risk management professionals deployed worldwide. In addition, more than 3,000 employees support the in-house risk management platform, and geopolitical and ESG risks are also covered on a global basis and the respective entities of each country, in addition to investment/operational risks, providing integrated risk management in a centralized manner.
- ■ Other examples include an independent asset manager that pursues investment return enhancement as a specialty, i.e., conducting no other business and focusing on only asset management, and another company that boasts of providing the total financial service package, i.e., emphasizing sales and marketing besides asset management. Note that both cases indicate they have clearly defined business models.

Example cases observed through FSA monitoring

- Major asset managers, which belong to financial conglomerate groups, including subsidiaries such as banks, brokerage firms and others have tended to develop and offer a full range of products, as they responded to a wide variety of product structuring as full-service asset managers in collaboration with sales functions both within and outside the group.
- These major asset managers recognize the existing distribution channel as a strength to capture diversified client needs. To respond to the needs, they aim to be "solution providers," possessing adequate capabilities in investment management and product development (portfolio construction).
- However, each company did not always seem to clearly define more concrete and resolute targeted-goal by utilizing the aspects of their competitive advantage that contribute to their clients' asset accumulation. Some of them seemed to have not yet progressed beyond internal discussions about the challenges they need to tackle to achieve their corporate vision, and furthermore, others did not seem to clearly define the corporate vision for their asset management business from conglomerate-group-wide perspectives.
- The following cases show that some companies are trying to establish their own core competence, and it is expected that these initiatives will lead to differentiation from other companies in the future.
  - An asset manager is trying to take advantage of an area where it has established an investment operational structure ahead of its competitors (e.g., alternative investments)
  - An asset manager is seeking to strengthen its global investment capabilities by utilizing its own network of overseas operation centers.
  - An asset manager is trying to share a communal corporate vision with its parent company and other affiliated companies, and aiming at strengthening the global investment capabilities as a group-wide project by acquiring shares of foreign asset managers and by other means.

Box 2: Typical business models in the current asset management industry

- Major domestic asset management companies are moving away from the traditional business model (A) below, which emphasizes sales, mainly through intra-conglomerate-group retail distributors, to become solution providers as (B), with investment management and product structuring capabilities necessary to meet the diversified needs of their clients.
- It is expected that each company will have a clearer idea of how it will leverage its strengths to help clients build their assets.



Source: Prepared by the FSA based on an analysis by Boston Consulting Group

II. Key challenge 4 . Business operations: Improving business operations to implement the corporate vison and core competence while prioritizing customers' interests ①

- To refurbish the asset management business, the senior management team at each asset manager must ensure that the corporate principles and philosophy, as well as the corporate visions and core competence, are thoroughly embodied at the operational level, while placing the highest priority on customers interests.
- Although each overseas asset manager has its own corporate vision and core competence, they have taken several notable initiatives to implement the corporate vision as follows: some asset managers devise recruitment, management, evaluation, and compensation structures to retain investment professionals; some asset managers proactively leverage new technologies; some asset managers implement stricter control over the fund capacity.
- Meanwhile, major asset managers in Japan are working to improve their business operations, but their progress varies widely. Further improvements are expected in the evaluation and compensation structure of executives and employees, as well as in fund structuring and business operations. In addition, it is also important to take specific measures to prioritize customer benefit to (1) strengthen competence in investment capabilities, (2) focus on products that can deliver robust consistent performances over the medium- to long -term, without unduly increasing the number of products, and (3) exercise rigorous management by streamlining funds by redeeming or consolidating unprofitable and/or small-sized investment trusts underperforming for a medium to long period of time.

Examples of overseas asset management companies

- ■ As the expertise required differs depending on the financial products, the investment unit takes the lead in recruitment and HR management. Asset managers hire and train the right people, who are deemed to fit the corporate culture, at the right time (In addition to mid-career hiring, new graduates recruits are also trained over time to evolve as investment professionals and retained going forward).
- ■ As for the evaluation and compensation structure applied for investment staff, fluctuations in AUM are not taken into account but assessed based on their medium to long-term performance. Most of the interviewed respondents stated that they evaluate performance on one to five year basis; however, some respondents evaluate on longer-term performance, such as eight to ten years, as their assets are under long-term management.
- ■ A portion of the manager's remuneration is used to purchase fund shares managed by that manager and/or their company, which will be paid out only after a few years. In this manner, the interests of managers are synchronized with those of clients.
- ■ An example indicates that the investment unit takes initiative to strictly control fund capacity even against flagship funds in active management (by using a "soft close" that allows to capital additions for existing investors only, or a "hard close" that stops any new capital additions) in active management, which emphasizes generating alpha (excess return). In this case, the first priority is to secure returns and protect existing investors.
- ■ Adopting technologies through proactive investments in IT and system development to expand investment product coverage and improve risk management
  - – Goldman Sachs Asset Management (U.S.) has been proactively using big data and alternative data for its quantitative strategy for over 30 years. Backed by the abundant talent pool, the company continues to hire specialists trained in computer science and utilizes the resources of the entire group to process the vast amount of data the company collects daily and utilizes it in their investments.

II. Key challenge 4 . Business operations: Improving business operations to implement the corporate vison and core competence while prioritizing customers' interests ②

Example cases observed through FSA monitoring

＜Securing investment professionals/evaluation and compensation structure>

- With respect to the recruitment and capacity building of investment professionals, the majority of Japanese asset management companies' approaches/initiatives have been limited to implementing training programs for junior staff and clarifying their career paths. Some asset management companies recruit and manage talents mainly through their investment units, adopt a designated recruitment practice for new graduates by specifying areas of expertise from the perspective of fostering/training them to become investment professionals, where systematic directions for professional development are clearly stipulated, including a provision to exempt them from general job rotation.

- With respect to the evaluation and compensation structure, some asset management companies have tried to introduce their own compensation structure (focusing on the quantitative evaluation of performance, performance based compensation, deferral of a portion of remuneration, and other measures), but there is currently a significant difference in the progress of these efforts among asset managers (e.g., average amount of remuneration, rate of increase or decrease based on performance, and the period of time subject to performance evaluation).

- Some experts, with whom the FSA conducted interviews about measures for the retention of talented professionals, noted that "were it not for changing the current HR management/practices and evaluation/compensation structure, it is inevitable that talented investment professionals leave the company because they would not feel their job status secured in the future at the company." From now on, it is expected that each asset management company will review the effectiveness of their initiatives and establish company specific HR management, evaluation and compensation structure, by establishing a compensation table to encourage the retention of talented professionals, rather than automatically adopting a compensation structure compatible with other affiliated companies within the same financial conglomerate.

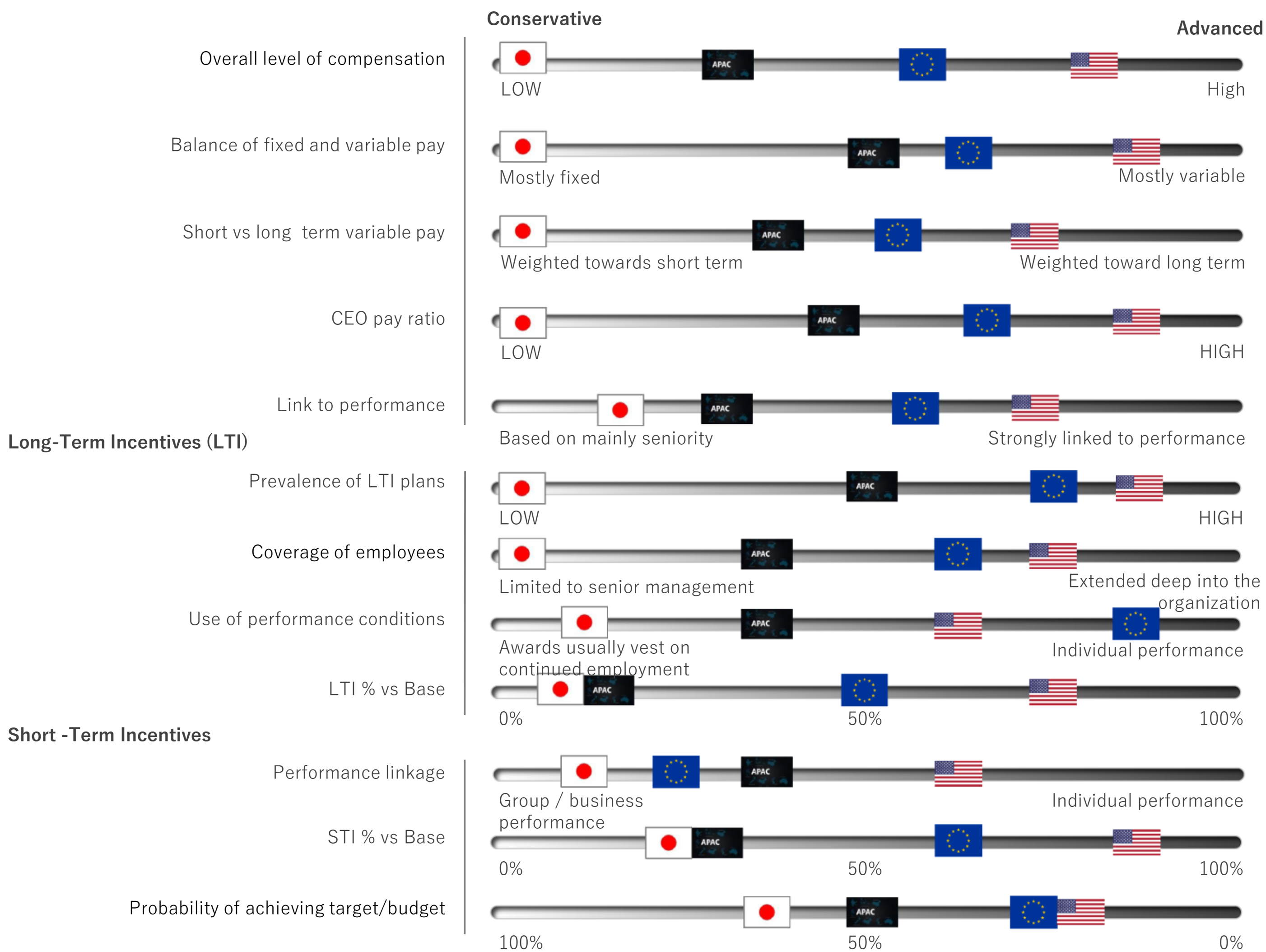
＜Fund management>

- In terms of capacity control to ensure performance, some asset management companies conduct systematic capacity management using their investment units setting maximum fund size. However, the companies differ in terms of how capacity was controlled.
- As part of the initiatives to enhance investment capabilities, it was recognized that some companies voluntarily disclose KPIs to show performance and establish internal KPIs to ensure performance, as well as have KPIs verified by the top management. Moreover, trends show that some companies have been enhancing their overseas operations to strengthen their own performance/capabilities and to improve their discernment in finding asset management partners as outsourcing contractors.

Box 3: International comparison of the asset managers' compensation system

- A survey commissioned by the Government Pension Investment Fund (GPIF) suggests that a typical compensation system of executives and employees of Japanese asset management companies tends to be more conservative than that of other countries, with a large proportion of fixed compensation and a low linkage between bonuses and investment performance.

※ To enhance investment returns over the long-run within a target range, asset managers are required to control incentives from becoming too excessive.



(Note) Based on questionnaires and interviews with the GPIF's trustee institutions. "APAC" stands for the Asia Pacific region.
(Source) GPIF Research Project, "Survey on the Compensation Structure (Incentive Scheme) of GPIF asset managers" (Mercer Japan Ltd., as of March 2019)

Box 4: Overview of the EU's MiFID II Product Governance Requirements

- In the EU, the Second Markets in Financial Instruments Directive (MiFID II) introduces a mechanism (product governance requirements) to ensure that asset managers (product composers/originators) and distributors provide financial products suitable for customers through mutual collaboration.
- Asset managers are required to identify the target customer segments when manufacturing financial products and to monitor the distributor through periodic reviews to confirm that the products are still suitable for the targeted segments even during the-post-sales stage.
- Under the supervision of the board of directors, distributors are also required to verify, at the time of sale and periodically after the sale, whether the financial product is suitable for the target investor segment, and to provide the asset managers with the information necessary for periodic reviews.

	Key responsibilities of asset managers (as product manufactures) <Compliance Unit is responsible for monitoring, whereas the Board of Directors is responsible for supervision>	**Key responsibilities of sales distributors** <Compliance Unit is responsible for monitoring, whereas the Board of Directors is responsible for supervision>
Governance in Product manufacturing and Sales	Pre-sales conduct ① Identify potential markets that are a good fit for the product, in terms of customer type, knowledge and experience, asset status, risk tolerance, and objectives and needs (as well as investor segments that are not a good fit for the product) ② Analyze whether manufacturing the product induces conflicts of interest to the detriment of investors. ③ Consider whether the product might have a negative impact on the market ④ Conduct scenario analysis in the event of a deterioration of the market environment ⑤ Consider whether the product's fee structure and its disclosure is appropriate in relation to the needs, objectives, and characteristics of the target investors Periodic Review Periodic review whether the structured product fits the needs, characteristics, and objectives of the target market basis on information obtained from distributors → Consider providing relevant information to distributors, revising the product approval process, stopping the additional issuance of products, reviewing the unfair terms and conditions of products, reviewing sales channels, discussing the sales process with distributors, terminating relationships with distributors, and reporting to the authorities in the event of cases not originally anticipated.	Pre-sales conduct Based on the information obtained from the asset management company, identify the actual investor base that is compatible with the product in terms of needs, characteristics, and objectives (and identify whether there is any investor base that does not fit) and develop distribution strategy accordingly. Periodic review Regularly check that the products recommended and sold fitting the needs, characteristics, and objectives of the target market. → Reconsider the target market if the product is no longer suitable for the originally targeted segment due to unforeseen events.
Coordination of information sharing between asset management companies and distributors	Provide a distributor with information about the product (including information on appropriate distribution channels, the product approval process, and an analysis of the target market).	Provide asset managers with the information necessary for their periodic reviews.

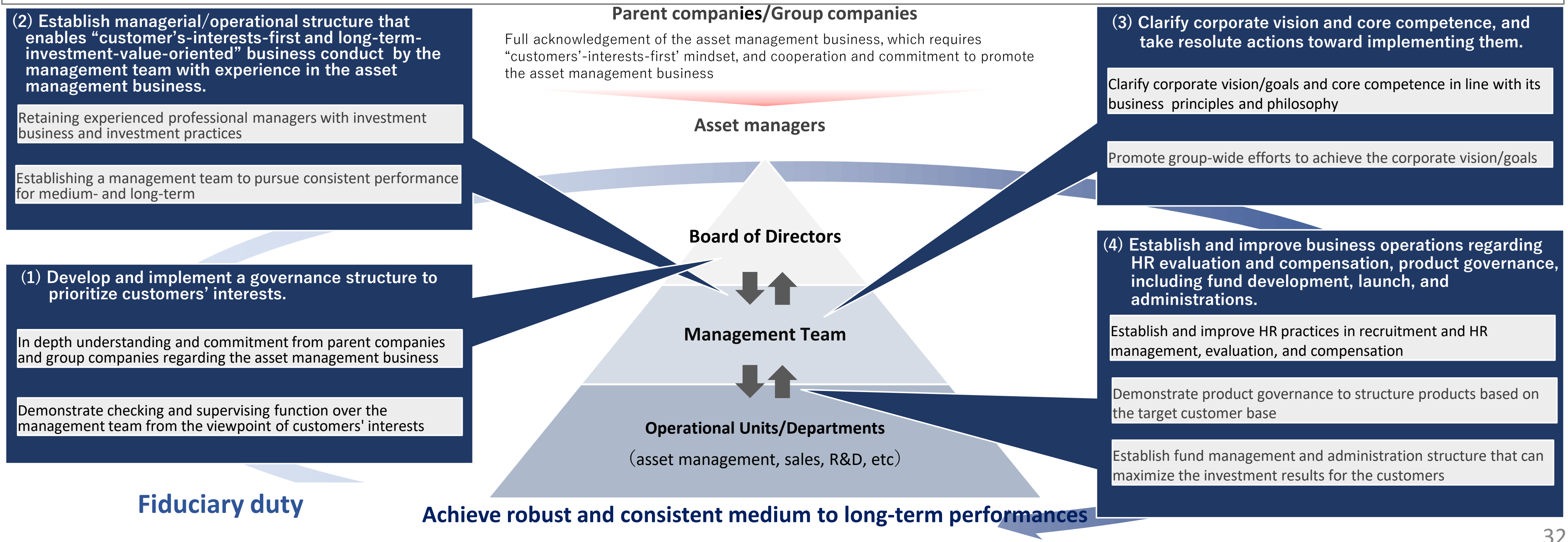
III. Course of action

1. Encourage asset managers' initiatives to achieve robust and consistent performance in mid-to long-run

- The FSA will continue to hold dialogues with the management teams of the domestic asset management managers and their parent companies (if applicable) so that each of them makes further efforts to contrive ways and promote the following initiatives:
  1. Develop and implement a governance structure functional to prioritize customers' interests.
  2. Establish managerial/operational structure that enables "customer's-interests-first and long-term-investment-value-oriented" business conduct by the management team with experience in the asset management business.
  3. Clarify corporate vision and core competence, and take resolute actions toward implementing them.
  4. Establish and improve business operations regarding HR evaluation and compensation, product governance including fund development, launch and administration.

  Promoting the initiatives listed above enables asset managers to provide customer-needs-oriented products, achieve robust mid- to long-term performances, gain the support and confidence of customers, and reinforce the company revenue base. To that end, it is imperative to (1) strengthen competence in investment capabilities, (2) focus on products that can deliver robust consistent performances over the medium to long -term, without unduly increasing the number of products, and (3) exercise rigorous management by streamlining funds via redeeming or consolidating unprofitable and/or small-sized investment trusts underperforming for a medium to long period of time.

- The FSA will also hold dialogues with independent and other distinctive asset management managers that achieve robust and consistent performance to discuss the contributing factors and robustness of their performance.



III. Course of action 2 . Other measures to refurbish the asset management business

- This report is organized based on an analysis of the current status and issues of publicly offered investment trusts for retail investors. In addition, it is necessary to refurbish the entire asset management sector, including privately placed investment trusts and discretionary investment management for institutional investors too.
- It is also important to promote adequate competition among asset management companies to sophisticate the asset management business. To that end, it is necessary to reinforce the "visualization" of the performance of publicly offered investment trusts and to take measures to invite new entrants.
- The FSA will continue to take effective measures on various issues related to the asset management business, taking into account the impact of COVID-19, which has profound implications on the future of the financial markets and the asset management business.

Visualization of investment performance

① Conduct surveys, analyze, and disclose the survey result regarding the status and issues of privately placed investment trusts and discretionary investment, which are mainly used by institutional investors such as regional banks and corporate pensions, through information gathering from asset managers, trust banks, and insurance companies.

② Extend research on the performance of public offered investment trusts by including research on foreign investment trusts (mutual funds) and the individual funds of each company besides the company-as-a-whole, and make it more regular basis and publish the results of the research to a wide range of stakeholders, including consumers, in a comprehensible manner.

Encouraging new market entrants

① Expedite the registration process to agglomerate the asset management industry by encouraging foreign asset managers and other entities.
② Distribute and publicize the Guidebook for Investment Management Business Registration Procedures released in January 2020, in collaboration with the contact points of the Tokyo Metropolitan Government and FinCity.Tokyo, both in Japan and abroad. Revise the Guidebook based on feedback from users.

Other initiatives

① Consider what roles the alternative investment funds such as PE funds are expected to play in the future economic climate, and the necessary policy treatments.
② Research and analyze the impact of the SDGs and ESG on the Japanese asset management business.
③ Research and analyze the functions of index providers in the asset management market.