Provisional Translation

Financial System Council
Working Group on Capital Market Regulations

First Report

Regulatory Policy: Toward an International Financial Hub

December 23, 2020

Table of Contents

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As of December 23, 2020

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Japan Securities Dealers Association　Japan Private Equity Association
Japan Venture Capital Association　Japan Exchange Group
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(Honorifics omitted, in order of the Japanese syllabary)

Introduction

In light of developments in the economy and society after COVID-19, it is vital that Japan's banking system and capital markets, the financial intermediary system as a whole, will strongly support a recovery of the real economy and industrial structural reforms after COVID-19.

At the General Meeting of the Financial System Council on September 11, 2020, the Minister of State for Financial Services delivered the following consultation:

"In light of the emergence of the post-COVID society and economy, such issues should be reviewed as approaches to facilitating provision of capital for growth, innovation and business restructuring, facilitating the entry of overseas financial institutions and sharing of clients' information between securities entities and banks, with the aim of recovering the economy and achieving sustainable growth through the better-functioning of Japan's capital markets, while giving due consideration to investor protection."

In response to this consultation, the Working Group on Capital Market Regulations was established under the Financial System Council. Since October 2020, the Working Group has held five sessions and discussed approaches to facilitating the provision of capital for growth, innovation and business restructuring, facilitating the entry of overseas financial institutions and sharing of clients' information between securities entities and banks, and interviewing market participants and stakeholders.

With regard to the better-functioning of Japan's capital markets as an international financial hub, it is expected that financial institutions' operations and transactions will become geographically diverse and deployed beyond national borders given the various changes occurring in the international economy and society, such as the emerging risk of concentrating business operations in a single location during the pandemic. Establishing international financial hub functions in Japan for Asia and the rest of the world would contribute to creating employment and industries and strengthening the nation's economic power. Moreover, the positive effects will not be limited to the Japanese economy; Japan would play a significant role in providing Asia and the rest of the world with public good having externality created by international financial hub functions by helping increase the resilience of Asia's and global financial markets through international diversification of risks.

Accordingly, it is essential to facilitate the entry of overseas investment managers as well as financial talents by making it easier to conduct business in Japan such as asset management with overseas clients that help attract financial talents, capital and information from overseas. Attracting financial talents such as fund managers to Japan will help improve the function and the attractiveness of Japan's financial and capital markets. This would ultimately enhance the financial business

services available to domestic customers.

A pressing issue in establishing international financial hub functions in Japan is further expediting the development of the environment for promoting the entry of overseas financial institutions, especially investment managers, and such efforts must be undertaken promptly. It goes without saying that improving the attractiveness of Japan's financial and capital markets will be essential to this end. At the same time, regulations should be revisited to ensure a level playing field between Japanese and overseas financial institutions in conducting international business.

This report summarizes the results of the Working Group's discussions on two of the issues: facilitating the entry of overseas investment managers and revising the firewall regulations concerning overseas corporate clients.

I. Facilitating the Entry of Overseas Investment Managers

1. Overview of the Current Regulatory Framework and Issues

1.1 Overview of the Current Regulatory Framework

Operating in Japan as an investment manager in principle requires registration as a Financial Instruments Business Operator with the competent authorities.[1] However, the following exemptions are specified in the Financial Instruments and Exchange Act (hereinafter, the "FIEA") for investment management businesses for which investor eligibility is restricted:

- For Investment Management Businesses for Qualified Investors,[2] some registration requirements are relaxed[3] when investors are limited to Qualified Investors and the total amount of the investment assets is limited to 20 billion yen at maximum.

- Specially Permitted Businesses for Qualified Institutional Investors, etc.[4] may conduct self-management[5] and investment solicitation for partnership-type collective investment schemes with notification to the competent authorities only when fund investors comprise one or more Qualified Institutional Investors and 49 or fewer specified investors.

1.2 Current Regulatory Issues

The following issues have been pointed out with regard to facilitating the entry of overseas investment managers:

(i) The current regulatory framework does not necessarily take into account overseas investment managers mainly managing foreign funds;

(ii) Neither overseas track records nor the ongoing supervision by foreign authorities is considered upon the entry and in the subsequent supervision of overseas investment managers managing only foreign funds.

With these issues in mind, the Working Group has discussed whether:

(i) Given that fund investors (clients) mainly comprise foreign corporations or individuals resident overseas (hereinafter collectively termed "foreign corporations, etc."), investment managers of

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[1] FIEA Article 29

[2] FIEA Article 29-5

[3] Some registration requirements are relaxed; for example, (a) they may be companies with auditors, not required to be companies with a board of directors, (b) the minimum capital requirement is lowered from 50 million yen to 10 million yen

[4] FIEA Article 63

[5] Self-management by fund managers of assets invested in the fund

such fund can be qualified to conduct business in Japan with a simplified entry scheme under a new type of investment management business;

(ii) Considering overseas track records and the ongoing supervision by foreign authorities,[6] overseas investment managers managing only foreign funds can be qualified to conduct business for a specified period (e.g., a few years) prior to registration in Japan.

2. Recommendations on Reforms of the Regulatory Framework

2.1 Simplified Entry Scheme for GP Managers with Overseas Qualified Clients

A. Key Concepts

For funds whose investors mainly comprise foreign corporations, etc., there would be little need to impose regulations similar to those imposed on investment management businesses for investors other than Professional Investors, considering that:

(i) Foreign corporations are deemed "Professional Investors"[7] under the current regulatory framework; and that

(ii) Individuals resident overseas with a certain level of assets are considered to have sufficient knowledge and experience concerning investment.

In conducting Specially Permitted Businesses for Qualified Institutional Investors, etc., it is necessary that fund investors comprise one or more Qualified Institutional Investors and 49 or fewer specified investors without exception. However, for example, though foreign corporations, etc. are required to possess a certain level of assets and notify the competent authorities in order to become a Qualified Institutional Investor, those who are eligible to become a Qualified Institutional Investor are not necessarily expected to notify the competent authorities. Thus, overseas investment managers with such investors may not be eligible for the Specially Permitted Businesses for Qualified Institutional Investors, etc. specified in the FIEA.

As noted above, however, there would be little need to impose regulations equivalent to those imposed on regular investment management businesses on fund managers for foreign corporations and individuals resident overseas with a certain level of assets. Hence, it would be appropriate to

[6] It was noted that it is important to consider how necessary it is to apply Japanese laws aimed at protecting investors to investment managers managing foreign funds and to consider whether investment managers exclusively managing foreign funds should be exclusively subject to foreign laws.

[7] FIEA Article 2, paragraph (31). Foreign corporations may request that they are treated as a customer other than a Professional Investor.

prepare a new type for fund managers mainly with those investors[8] that may operate in Japan[9] with notification. The new type will not require investment by a Qualified Institutional Investor nor will the number of specified investors be limited.[10]

B. Type of Applicable Investment Management Businesses

Investment management businesses that require registration in Japan are currently classified by investment vehicles into (a) self-management of interests in partnership-type collective investment schemes, (b) investment management of domestic or foreign investment trusts, (c) investment management for domestic or foreign investment corporations, or (d) investment management under a discretionary investment contract. The scope of the new type is thus a key point for discussion.

The framework of "self-management of interests in partnership-type collective investment schemes" in (a) above would be generally more flexible than that of other types of investment management businesses. Also, various fund management businesses such as venture funds, hedge funds and real estate funds are subsumed under this type. In addition, although the new type presumes that fund investors mainly comprise foreign corporations or individuals resident overseas with a certain level of assets, this presumption may not hold if rights held by investors have high liquidity such as investment trusts as these rights could be repeatedly distributed.

Therefore, the new type should cover the "self-management of interests in partnership-type collective investment schemes" in (a) above in which rights held by investors have low liquidity,[11] as in the current framework for Specially Permitted Business for Qualified Institutional Investors, etc.

C. Conduct Controls and Supervisory Responses

The duty of loyalty to customers, the duty of due care of a prudent manager and other conduct controls are imposed on registered Investment Management Business Operators in the interest of investor protection. Moreover, these investment managers are subject to supervisory responses such as business improvement orders and on-site inspections by the competent authorities. Specially

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[8] There was a comment that requirements should be considered given that a Japanese could establish a foreign corporation under the jurisdiction of foreign laws to invest in a fund indirectly through this foreign corporation, if funds invested by a foreign corporation are deemed eligible for the new type pro forma.

[9] Given the aim of facilitating the entry of overseas investment managers into Japan and the need for supervisory responses by Japanese authorities as described below, it would be appropriate to require investment managers entering the Japanese market to establish a business office in Japan.

[10] There was a comment that it is important to clearly explain the aim and the reason for facilitating the entry of overseas investment managers as the addition of a new type could make the regulatory framework more complex.

[11] There was a comment that it should be reviewed whether "investment management under a discretionary investment contract" in (d) should be covered by the new type if significant business needs are identified in the future.

Permitted Businesses for Qualified Institutional Investors, etc. who have notified the competent authorities are also basically subject to conduct controls and supervisory responses equivalent to those for investment management businesses. The applicability of such controls and responses to the new type is thus another key point for discussion.

As the FIEA ensures a certain level of investor protection for foreign investors, such protection would be required under the new type as well. Also, Financial Instruments Business Operators, etc. already engaged in business in Japan are subject to conduct controls and supervisory responses, and hence ensuring a level playing field with those operators is important. Additionally, as the new type will not require investment by a Qualified Institutional Investor nor will it restrict the number of specified investors, it would be necessary for the competent authorities to take such investor protection measures as supervisory responses including information sharing with foreign authorities.

Thus, it would be appropriate in principle that the new type will be subject to conduct controls, supervisory responses and on-site inspections by the competent authorities equivalent to those applicable to regular Investment Management Business Operators, as in the framework for Specially Permitted Businesses for Qualified Institutional Investors, etc.[12]

D. Investment by Domestic Investors

When investment managers whose investors mainly comprise foreign investors enter the Japanese market to engage in fund management business, investment needs from domestic investors could arise. Permitting a certain degree of investment by domestic investors would then be desirable, considering that foreign funds will act as a catalyst to stimulate investment by those investors. On the other hand, permitting investment by domestic investors other than Professional Investors would be inappropriate in light of the purpose of the new type and the interest of investor protection.

Consequently, investment by certain domestic investors deemed professionals (Qualified Institutional Investors and personnel relevant to investment managers) should be permitted up to a pre-determined percentage, striking a proper balance between investment needs and investor protection. Based on the premise that these investment managers mainly manage foreign funds, the percentage of investment by such domestic investors should be kept to less than 50%.

[12] Given that retail investors were victimized by numerous cases of fraud through Specially Permitted Businesses for Qualified Institutional Investors, etc., regulatory amendments were made in 2015 revisions to the FIEA that included the introduction of conduct controls and supervisory responses.

E. Scope of Applicable Investment Managers

The aforementioned discussion aims to facilitate the entry of overseas investment managers. Nevertheless, domestic investment managers who satisfy the requirements that fund investors mainly comprise foreign corporations or individuals resident overseas with a certain level of assets should also be eligible for the new type in order to ensure a level playing field.

F. Solicitation for Acquisition

It is possible that investment managers entering the Japanese market under the new type will engage in solicitation for acquisition of interests in partnership-type collective investment schemes for foreign corporations, individuals resident overseas with a certain level of assets and specified domestic investors mentioned above. However, registration for Type II Financial Instruments Businesses is in principle required to conduct such business in Japan. As Specially Permitted Businesses for Qualified Institutional Investors, etc. are eligible to engage in solicitation for acquisition of interests in partnership-type collective investment schemes with notification, those entering under the new type should be permitted to likewise engage in solicitation for acquisition with notification.

2.2 Pre-Registration Entry Scheme for Investment Managers Managing Only Foreign Funds

A. Key Concepts

Investment managers managing only foreign funds that are subject to foreign laws and regulations require a certain amount of time to complete registration procedures under the current regulatory framework when entering the Japanese market. Hence, it would be important to prepare an entry scheme that takes into consideration foreign regulations and track records in order to facilitate the entry of these investment managers into the Japanese market.

More specifically, given their proven track records and authorization by foreign authorities in specified foreign countries, the new exemption should be prepared that permits those managing only foreign funds to continue ongoing overseas investment management businesses, etc. in Japan with notification for a specified period until registration procedure, etc.[13] is completed.

B. Permissible Period for Operation and Implementation as a Time-Limited Measure

In accordance with the purpose of the new exemption, it would be necessary to set a specified period for operation in Japan. As overseas investment managers will need to build up track records in Japan and thereafter complete registration procedure, etc. stipulated by the FIEA, it would be appropriate to set a transition period of

[13] This refers to any of the permanent type of Investment Management Business, Investment Management Business for Qualified Investors, Specially Permitted Business for Qualified Institutional Investors, etc. and the aforementioned “simplified entry scheme for GP managers with overseas qualified clients”.

"about five years" and to require them to engage in a permanent type of investment management business by the end of this transition period.

Similar to the aforementioned new type specified in 2.1, the new exemption could be prepared as a permanent measure. Nonetheless, given the aim of intensively attracting overseas investment managers to Japan and from the perspectives of a level playing field with existing investment managers and investor protection, the new exemption should be prepared as a time-limited measure valid for "about three to five years."

C. Requirements for Eligible Investment Managers

The new exemption would presume investment managers already engaged in management business overseas and mainly managing foreign securities under the supervision of foreign authorities. Therefore, it would be important to take into account that (a) they continue to hold valid authorization by foreign authorities while operating in Japan,[14] (b) they have proven track records overseas, and that (c) they engage in mainly managing foreign securities (with domestic securities up to less than 50% of assets under management of their funds).

In addition, as regular Investment Management Business Operators are required to be adequately staffed and establish operational control systems to properly conduct financial instruments business (i.e. reasons for disqualification), it would be appropriate to require those entering the Japanese market under the new exemption[15] to be adequately staffed and establish operational control systems.[16]

D. Scope of Foreign Authorities Granting Authorization

In light of investor protection, the scope of foreign authorities should be considered under the presumption that they are the Foreign Financial Instruments Regulatory Authority that has made the assurance that the authority will respond to requests for cooperation in investigation from Japan,[17] and that their regulations and supervision satisfy investor protection requirements. In other words, the basic criteria should be that a foreign country has

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[14] There was a comment that although small asset management companies would incur significant costs when required to have a business office in Japan and overseas, it would be reasonable to require them to hold continued authorization by foreign authorities given the risk of the absence of supervision and investor protection concerns.

[15] There was a comment that these and other requirements should be as specific and objective as possible so they would be predictable enough for overseas investment managers entering the Japanese market.

[16] From the same perspective, it would be appropriate to apply these requirements to investment managers entering under the aforementioned "simplified entry scheme for GP managers with overseas qualified clients."

[17] "The Foreign Financial Instruments Regulatory Authority that has made the assurance that the authority will respond to requests for cooperation in investigation from Japan" refers to, for example, a signatory to the Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information ("Multilateral MOU"), a framework set by the International Organization of Securities Commissions (IOSCO). The Financial Services Agency, the Ministry of Economy, Trade and Industry and the Ministry of Agriculture, Forestry and Fisheries are signatories to the IOSCO Multilateral MOU mentioned above.

market rules equivalent to those in Japan and conducts effective supervision essentially under the same principles as Japanese supervisory authorities.

3. Measures other than Reforms of the FIEA

In order to facilitate the entry of overseas investment managers into Japan, it is significant to implement reforms to make Japan's financial and capital markets attractive and comparable to their foreign counterparts, not only by simplified entry schemes mentioned above but also by measures such as facilitating provision of capital for growth, innovation and business restructuring. It is also important to develop an environment that makes it easier for overseas investment managers to conduct business in Japan by, for example, removing bottlenecks in the tax system, handling the regulatory process from pre-application consultation, registration to supervision for newly entering asset management firms in English,[18] and relaxing residence status requirements. Therefore, it would be essential to continue to take measures comprehensively and strategically on improving the attractiveness of Japan's financial and capital markets and on developing an environment that attracts overseas investment managers so as to establish international financial hub functions in Japan.[19]

[18] Applications for registration from newly entering asset management firms are set to be accepted in English from January 2021. In conjunction, the Financial Services Agency and Local Finance Bureaus are set to establish "Financial Market Entry Office" to handle the regulatory process including online pre-application consultation from overseas for newly entering asset management firms as a single point of contact (January 2021).

[19] With regard to measures other than reforms of the FIEA, the Working Group members made such comments as: "When disseminating information overseas on the applicability of the new rules, it is important to prepare plain guidelines, etc. so the coverage of the FIEA and other regulations can be clearly understood," "Smooth communication is needed as well as communication in English, so timely and smooth administrative services via e-mail are important," "As customer-oriented business conduct is a precondition for those entering under the new type and the new exemption, it is essential that business be conducted with due consideration to the effective enforcement of fiduciary duties" and "It is needed to actively promote RegTech measures in such areas as reducing the burden of reporting to authorities, cutting supervisory costs, and clarifying regulatory details in order to facilitate the entry of overseas financial institutions and to enhance Japan's international competitiveness."

II. Revising Firewall Regulations Concerning Overseas Corporate Clients

1. Background and Objectives of Review

The firewall regulations include the restrictions on the sharing of clients' information[20] between banks and securities entities within the same financial group without customer consent. The regulations were introduced in 1993 when the prohibition of banks' and securities firms' mutual entry to the banking and securities business was lifted in order to ensure:

- fair competition between securities firms (by the prevention of sales over undue influence of a "main bank" within a financial group, etc.);
- proper management of conflicts of interest; and
- robust protection of clients' information, etc.

Serial reforms have been implemented, particularly the major reforms adopted in 2008 (that introduced an opt-out consent system and the obligation to establish conflict-of-interest management systems), considering regulatory developments in other jurisdictions and a right balance in line with the regulatory objectives.

"Follow-up on the Growth Strategy" (Cabinet decision on July 17, 2020) stated: "Lifting of the firewall regulations concerning overseas corporate clients should be considered. Moreover, the need for the firewall regulations concerning domestic corporate clients should be reviewed with a fair competitive environment in mind." This aims to ensure a level playing field between Japanese and overseas financial institutions and to improve the attractiveness of Japan's financial and capital markets.

2. Overview of the Current Regulatory Framework and Issues Concerning Overseas Corporate Clients

The firewall regulations require in principle securities entities to obtain prior written consent from clients to share clients' information between banks and securities entities within the same financial group.[21] On the other hand, the sharing of clients' information regarding overseas corporate clients is allowed when clients show their consent by opt-out and prior written consent is permitted to be obtained by e-mail in exemptional circumstances.[22]

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[20] This refers to material non-public information and non-public loan information, etc.

[21] This also includes the information sharing between banks (registered financial institutions) or securities entities on the one hand and their parent/subsidiary companies, etc., on the other.

[22] If the laws and regulations of the country where the overseas corporate client is located do not have any regulations requiring written client consent before a securities firm and its parent/subsidiary company share clients' information, consent will be deemed to have been given if the following conditions are met: a declaration of the client's intention to allow the information sharing is issued by means of electronic records; or a declaration of the client's intention to allow the information sharing can be reasonably constructed

For example, a Japanese bank or securities firm seeking to share clients' information within the same financial group in order to undertake a cross-border M&A would in principle need to obtain prior written consent. Concerns have been raised in this regard that: obtaining written consent from companies located in countries without similar regulations has proven difficult, putting Japanese financial institutions at a competitive disadvantage vis-à-vis overseas financial institutions that are not subject to the regulations; and the regulations would limit corporate clients' access to holistic proposals from Japanese financial institutions as a group.

3. Recommendations on Reforms of the Regulatory Framework

Regarding the concerns raised above, the following views were expressed in the Working Group's discussions:

(i) The firewall regulations concerning overseas corporate clients should be revised, aimed at ensuring regulatory equivalence with global standards and strengthening international competitiveness vis-à-vis overseas financial institutions, etc.;

(ii) With developments of practices for customer protection such as conflicts of interest management in other countries, it would not be necessary to additionally require compliance with Japanese regulations as well as with the regulations applicable in countries where corporate clients conduct business.

Based on these views, it would seem appropriate to lift the restriction on the sharing of clients' information concerning overseas corporate clients.[23]

from the provisions of an agreement on the sharing of clients' information and the business practices of the country where the client is located.

[23] Further discussions on non-public information, etc., concerning domestic corporate clients will continue, and the scope of overseas corporate clients from which prior consent will be no longer needed should be appropriately defined to avoid regulatory arbitrage pertaining to the firewall regulations concerning domestic corporate clients.

Conclusion

The above recommendations are the results of the Working Group's discussions on facilitating the entry of overseas investment managers and revising the firewall regulations concerning overseas corporate clients. We hope that appropriate measures will be taken based on the policy directions presented in this report to enhance the function of Japan's capital markets as an international financial hub.

The Working Group will continue discussions on the remaining issues including approaches to facilitating the provision of capital for growth, innovation and business restructuring, and the firewall regulations concerning domestic corporate clients.