AIMA

Elevate Japan's Stature as a Global Financial Centre

A STRATEGIC ROADMAP

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DISCLAIMER

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TABLE OF CONTENTS

1 Introduction 4

2 Recommendation 5

3 Corporate and Individual Tax Rates 6

4 Pension Fund Contributions 6

5 Market Access and Regulation 7

6 Sustained Support 9

7 Internal Control Resources 10

8 Tax 11

8.1 Modification of Permanent Establishment income exemption, simplification of filing process and introduction of PE exemption 11

8.2 Modification of the filing process for disposal gain of funds 11

8.3 Expansion and simplification of director bonus deduction claims 12

8.4 Expansion of carried interest taxation to funds other than partnerships 12

8.5 Expansion of inheritance tax rule 13

1. INTRODUCTION

The Alternative Investment Management Association ("AIMA") is wholly supportive of the initiatives the Government of Japan has undertaken to open its market to foreign firms and elevate Japan's stature as a regional and international financial centre. Indeed, we believe this is not only critical to the long-term prosperity of Japan but also to its broader foreign policy objectives.

AIMA is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries who collectively manage more than US$2.5 trillion in assets. As such, AIMA can share the voice of foreign asset managers and the barriers they face both when entering Japan and in building long-term businesses that contribute to the more effective functioning of the Japanese financial system.

While small incremental changes and financial incentives have been implemented in an attempt to attract foreign asset management firms, we believe these will ultimately not achieve the desired policy objective and that now is the time to take bold steps to address structural barriers and create substantial long-term benefits for the future.

It is only through resolute and sustained government level commitment and action on these issues that Japan will be able to take its rightful place as a leading global financial centre.

2. RECOMMENDATION

- Review corporate tax rates to better align these with those of other financial centres (below 30 percent) and introduce mechanisms that allow lower effective individual tax rates (below 40 percent).

- Support the long-term growth of Japan by increasing voluntary personal pension contribution allowances.

- Implement practical and usable exemptions based on the principle of sufficient equivalence of regulation in the foreign manager's home jurisdiction in another major financial centre. This can be limited to where permitted activities are only solicitation to institutional investors of interests in offshore funds managed by an affiliate or the asset manager has significant assets under management and a significant number of existing investors.

- Make English language supervision available for existing registrants should they wish in addition to the program which is in place for new registrants.

- Establish an official roundtable or forum for the voices of foreign asset managers which policymakers and regulators can listen to, consult and deliberate with concerning global financial regulatory issues and priorities for the Japanese financial system.

- Allow the outsourcing of the compliance function and permit compliance officers registered in Japan to serve as compliance officers of group companies concurrently without requiring them to be located solely in Japan.

- Introduce tax simplifications and expansions covering permanent establishment exemptions, director bonus and carried Interest deduction claims.

3. CORPORATE AND INDIVIDUAL TAX RATES

The high level of statutory corporate and individual tax rates in Japan is the key issue hindering the entry of foreign financial services businesses into Japan as well as the expansion of their operations on a large scale.

As compared to the corporate and individual tax rates in the nearby international financial centres of Hong Kong and Singapore, Japan's statutory tax rates (34% for companies and up to 56% for individuals) are almost double the corporate and triple the individual rates.

Whilst there are some moves towards increasing tax rates in some overseas jurisdictions, Japan still remains an unfavourable outlier for doing business not only in the region but globally and this undoubtedly affects Japan's ability to become a global financial centre. This may be the hardest reform of all to implement but without a reduction in tax rates for companies (to below 30 percent to match the global trend) and individuals (to below 40 percent) attaining the stated goal of being a world-class financial centre will never be sustainable.

Targeted policy options are also available and while Japan has found it difficult to successfully implement special economic zones, we believe that the potential for rapid economic growth and the development of a specific area via the establishment of a permanently lower tax zone with appropriate infrastructure is too great to ignore.

4. PENSION FUND CONTRIBUTIONS

It is also noted that large challenges such as tax reform can present outsized opportunities. For example, the sustainability of Japan's pension system has become a significant issue as the ageing population of Japan continues at a rate higher than projected. The available policy responses include raising the retirement age, increasing other taxes, reducing the pension benefit level and increasing pension contributions. While these are all difficult approaches that consume political capital, tax efficient reform of voluntary contributions to corporate and individual pension plans would have multiple benefits of lowering effective tax rates, supporting individuals in their retirement and also lead to higher rates of investment in Japanese equities and higher potential economic growth.

For international comparison, Japan's Defined Contribution plans are similar to the 401(k) in the US or the UK's Self-invested personal pension (SIPP). However, the annual contribution limit for a Japanese defined contribution plan is extremely low at JPY 660,000 per year versus c.JPY 9,600,000 (US$ 66,000) in the United States and c.JPY 11,000,000 (GBP 60,000) with the UK's SIPP allowing tax free access to those retirement funds from age 55. Other tax efficient retirement schemes such as the Australian Superannuation system present a very successful model with known outcomes.

We therefore propose that the voluntary pension fund contribution levels should be reviewed to enable long-term investment in Japan and support the structural issues associated with the ageing population.

5. MARKET ACCESS AND REGULATION

The Japanese asset management industry is concentrated with the bank sector dominating financial intermediation and access for foreign asset managers in Japan and market-based access in general remains substantially underdeveloped.

The market power of the Japanese "mega-banks" results in limited options and higher fees for Japanese investors. This is reinforced by restrictive and convoluted licencing requirements for market entry.

More specifically, the requirements for investment management registration are overly extensive and pose significant challenges for a new manager or a recent entrant. As such a licensing exemption is required for managers for example those only soliciting for interests in offshore funds to institutional or sophisticated investors as this aids in the better functioning of the economic system. Managers are currently required to be registered as a broker-dealer (Type I Financial Instruments Business Operator) to offer their own or their affiliates' open-ended funds (or else are forced to engage a local Japanese distributor) setting a significant hurdle. We believe an expansion of the self-solicitation regime is required to remedy this situation.

In order to be licensed to engage in investment management business, which includes providing certain fund management services, investment trust management services, investment corporation asset management services and discretionary investment management services, an applicant would have to satisfy very strict licencing requirements and is required to have a high level of internal control including the hiring of a number of professional personnel from day one, regardless of the size of the business, complexity or nature of prospective investors.

This substantially increases costs and operational complexity for foreign asset managers and we believe a simpler regulatory system for entry-level new managers would enable Japan to become a financial centre.

While a robust overhaul of the Financial Instruments and Exchange Act (FIEA) could be an appropriate way to simplify the regulatory regime, we believe a system of safe-harbour exemptions and clear regulatory guidance would be a good starting point.

We acknowledge the recently enacted exemptions allowing the entry of foreign managers into Japan under transitional arrangements if regulated overseas. However, we note for example that investors must be limited to non-Japanese investors primarily or the entrant must not primarily invest in

Japanese companies. In addition, for example, the exemption for investment management business for professional investors strictly limits the size of assets to less than JPY20 bn (c.US$ 140m) while the requirements are kept high.

The conditions to rely on these exemptions have resulted in limited opportunities for foreign asset managers to enter or expand their business in Japan, meaning these exemptions are ineffectual and impotent in practice. In fact, the reality is there are few firms which have utilised these exemptions.

We see a fundamental mismatch between the risks associated with the solicitation activities of global asset managers focused solely on institutional investors and the licencing regime for financial instruments business operators in Japan.

Generally speaking, as mentioned above, a foreign asset manager entering Japan to raise capital and undertake distribution for investments in an offshore open-end fund managed by an overseas affiliate requires a Type I Financial Instruments Business Operator licence registration. However, this licence is designed for broker-dealers and covers activities such as intermediation, brokerage, dealing, underwriting, IPOs and private placement. It requires for example daily calculation of capital adequacy ratios, monthly data submissions to the Financial Services Agency (FSA) and membership of Self-Regulatory Organisation the Japan Securities Dealers Association which has its own bespoke rules.

It is not recognised that foreign asset managers soliciting in Japan do not hold client money, are not involved in transactions into the offshore funds and that it is not possible to commingle the offshore fund investments with the assets of the manager.

We propose this requirement be relaxed by way of widening of an exemption for foreign asset managers solely soliciting institutional investors for interests in funds managed by affiliates who are licensed in another highly regulated jurisdiction.

Indeed, other key jurisdictions such as the US have implemented so-called “issuer exemptions” which allow persons associated with an issuer or its affiliate (including an affiliate of an investment manager to a relevant fund) to solicit investors without being registered as a broker-dealer as long as the strict condition that it does not undertake solicitation for third parties unaffiliated with the issuer.

In Japan, the scope of "issuer-self solicitation" *(jiko boshu)* is significantly limited and often not usable for fund managers when selling interests of the funds they or their affiliates effectively manage. Furthermore, an exemption is not available for funds that are formed as investment trusts or corporate funds. This inhibits the growth of the industry as many funds are structured as investment trusts and the process for solicitation even for fully licensed managers is cumbersome which often leads to a focus on seeking investors outside of Japan instead.

In addition to issuer exemptions, we note some jurisdictions have an exemption for entry-level managers based on the size of the assets a manager manages and number of investors which is also a model worth considering.

Foreign managers have found that the need to be registered as Type I Financial Instruments Business Operator and/or Type II Financial Instruments Business Operator in addition to Investment Manager registration presents an extremely high barrier to entering the Japanese market.

As such, practical and usable exemptions based on the principle of sufficient equivalence of regulation in the foreign manager’s home jurisdiction, with activities limited to the solicitation to institutional investors of interests in offshore funds managed by an affiliate, have the power to structurally change market access and the investment choices available to Japanese investors and to turn Japan into a leading global financial centre.

6. SUSTAINED SUPPORT

When Japan faced pressure to open its market in the 1990’s this resulted in the establishment of new trust banks by foreign banks in Japan. However, due to the operational difficulty of operating in Japan and inability to build meaningful scale there remains only one of these today.

This illustrates clearly that the model for real success should not be based upon short-term incentives and key performance indicators of the number of successful licence applications by new entrants but instead on establishing changes that support foreign firms, including existing foreign firms in Japan, on their multi-decade journey of business building.

While we support the recent strategic priorities to expand the scope of foreign firms for which English communication is made available to include foreign securities firms, the availability of English language supervision should not be limited only to new registrants, with this being clearly unjust, English language supervision should also be available for existing registrants should they choose.

Expansion of the businesses of existing foreign asset managers who have already committed and invested numerous years contributing to the Japanese financial system should be an equal if not higher priority for policymakers.

We believe that a pilot program for a small group of existing registrants would likely inform the level of resources that are required by the FSA and should help the FSA to expand the eligibility in accordance with its strategic priorities without placing undue strain on the internal resources of the FSA.

Given the concentrated nature of the asset management industry in Japan and the relatively small total number of foreign asset managers, estimated at around 70, if resources cannot be acquired to achieve this, then there is little hope for Japan to become an international financial centre.

Indeed, it is the voices and experiences of the existing established foreign asset managers in Japan which policymakers and regulators should listen to. As such we propose the establishment of an official roundtable or forum for foreign asset managers which policymakers and regulators can directly listen to, consult and deliberate with concerning global financial regulatory issues and priorities for the Japanese financial system.

7. INTERNAL CONTROL RESOURCES

The illiquidity of human resources is a continued problem in the Japanese market. As a consequence, it has been very difficult for foreign asset management firms to hire the required personnel in particular a dedicated compliance officer when applying for licensing registration. However, we believe this issue can be resolved if the Japanese regulator allows more flexibility in satisfying the requirement.

Currently, the Japanese regulator appears to place too much emphasis on having one local compliance officer who satisfies certain strict criteria (e.g., number of years of relevant experience and appropriate titles of the positions held) which is recognised to be extremely challenging to fulfil. However, it is not only unnecessary but also promotes organisational instability should something happen to that compliance officer.

International or multinational asset management firms implement internal control globally and assign a team of compliance staff to effectively cover every region they operate in while utilising external resources such as local law firms and compliance consultants. Japanese compliance, therefore, can be managed globally in an effective and efficient manner similar to other jurisdictions. Local nuance should of course be addressed and thus we understand the need for on-the-ground compliance support, but it does not always mean that the firms must appoint a Japan dedicated compliance officer who meets certain criteria put forth by the Japanese regulator.

We propose that greater flexibility should be provided to firms in satisfying this requirement, for example, by allowing a complementing compliance function within global compliance functions and the outsourcing of the compliance function similar to those who apply for transitional investment manager exemption or professional investor-only exemption. In addition, a Japanese compliance officer should be allowed to serve as the compliance officer of group companies concurrently and should not be required to be located in Japan.

We also believe the Japanese regulator should consider implementing measures and provide resources to promote education so that the next-generation compliance staff can be developed and the talent pool increased.

8. TAX

8.1 Modification of Permanent Establishment (PE) income exemption, simplification of filing process and introduction of PE exemption:

Under the current Japanese taxation, if the General Partner (GP) of a foreign fund operates in Japan with the newly introduced simplified scheme or existing FIEA article 63 notification, the GP or the fund is deemed to have a presence in Japan as are consequentially the foreign Limited Partners (LP). The foreign LPs must then seek to apply for Permanent Establishment (PE) income exemption to be exempt from Japan tax where satisfying certain conditions and must prepare the application form for each fund and file it with the relevant tax office through the GP. The fact that a foreign LP is deemed to have a PE in Japan would prevent a foreign funds/foreign manager from operating in Japan. Some of the conditions for PE income exemption are difficult to meet, especially for large foreign investors. The burdensome requirements are inefficient and inconsistent with global practices. Currently, newly introduced regulatory licensing exemptions for foreign investor exemption are not utilised because of these tax rules.

We recommend, similar to other international financial centres such as US and the UK, PE exemption should be granted to securities investment so that even when a GP's role is conducted in Japan, this does not trigger PE for foreign LPs.

Even when the PE exemption is difficult to achieve, we request that the conditions for qualifying for the PE income exemptions should be relaxed for instance, approving/disapproving certain investment matters by the LPs should not be considered as management of the fund and the conditions should be limited only to the matters that are akin to the GP's fund management. Currently, in US or European partnerships, certain approval/disapproval rights (mostly on conflict of interests matters) are often granted to the limited partnership advisory committee (LPAC) where major limited partners will be members. If the foreign investors similarly have the right as members of the LPAC in a partnership where the GP conducts its management role in Japan, under the current conditions, even though the role is for the benefit of other limited partners, such as checking conflict of interest matters, the foreign investors cannot meet the PE income exemption test.

In addition, we recommend a review of the filing administrations and that the filing obligations fall only on the GP so foreign LPs are a step removed from such administrative matters.

8.2 Modification of the filing process for disposal gain of funds:

Upon divestment of a fund, foreign LPs are required to file tax returns or domestic exemption or treaty relief for tax on disposal gain within two months from the day following the end of their fiscal year in which the sale occurred (or by March 15 of the calendar year following the year of sale for individual). Local agents have to be appointed by the foreign LPs to process all the filing after exit. In addition, as the fund and the LPs may have a different fiscal year and the financial statements of the fund may not be finalised until the fiscal year of the LPs, information may not be made available to the LPs by the filing deadline.

As with PE income exemption, we recommend a review of the filing administrations and that the filing obligations falls only on the GP so that the foreign LPs are a step removed from such administrative matters. Moreover, consideration should be given to allowing the GP to file tax returns and settling tax liabilities on behalf of the LPs who do not qualify for the domestic exemption or tax treaty relief. Furthermore, we suggest allowing the GP to extend the filing deadline.

8.3 Expansion and simplification of director bonus deduction claims:

The deduction of director bonuses for private asset managers introduced in the 2021 tax reform was in principle at least an attractive measure to private asset managers. However, the conditions for fulfilling the deduction claim are too difficult to meet. Some of the conditions, such as approving the calculation in the investor meetings and publishing the calculation methods on the FSA website, are impractical for how global asset managers operate. In addition, restricting “family corporations” from enjoying the deduction claim also sets up a barrier for many taxpayers, such as family offices and hedge funds.

We recommend amending the director bonus rules to permit companies licensed under the FIEA ("Specified Companies") to deduct incentive bonuses paid to directors; or at least further expand the 2021 director bonus rule for Specified Companies so that a “family corporation” can also be eligible, together with further simplification measures.

8.4 Expansion of carried interest taxation to funds other than partnerships:

The clarification of carried interest taxation rule in 2021 tax reform has been very well received by the market. However, there are many private equity, venture capital and hedge funds which are not established in the form of partnerships. This creates an undue bias in the market in favor of a certain form of fund simply on the basis of the individual tax treatment of the fund manager which is not sensible in terms of having the ability and desire to offer a variety of fund platforms for all types of client investor circumstances.

We request further clarification or reform to expand the conditions to global and local funds in legal forms other than partnerships, such as corporate funds and unit trust funds.

In addition, the timing of income recognition should be at the time of distribution, rather than an accrual basis. As such, the carried interest taxation should be available in principle to all types of funds regardless of their entity type subject to matching conditions. In addition, the FSA guideline should clarify that carry payment calculation basis other than “hurdle rate”, such as “high water mark”, should also be acceptable as far as it is reasonable.

8.5 Expansion of inheritance tax rule:

After the 2021 tax reform, if non-Japanese residents come to Japan with their family, their spouse or children, they can still be subject to Japanese inheritance tax for their assets outside of Japan if they stay in Japan for more than 10 years within the past 15 years.

The scope of inheritance tax should be revised so that the foreign assets do not fall within the scope of Japanese inheritance tax regardless of the period of stay in Japan of the heir. This will allow greater flexibility to foreign-based fund managers considering a return to Japan and to dispense with an arbitrary cut-off of the limit of 10 years; at a time when foreign managers are likely to be the type of experienced advisers who should be actively encouraged to stay in Japan rather than in effect being encouraged to depart due to the risk of heavy inheritance tax on assets that are not and never were within the Japanese tax net.

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