

The Power of Investor Pushback And Regulatory Change. Case Study: Japan

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Examining the Japanese market, the author of this article looks at how to answer clients when they ask why fund marketing regulations are so complex, vague and often overly restrictive?

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Global Sales Compliance has been tracking the evolutionary development of country fund marketing regulations in 60-plus jurisdictions for more than two decades.

When we advise clients on marketing their funds in numerous jurisdictions, clients frequently ask: “Why”? “Why are fund marketing regulations in a specific jurisdiction so strict/overly complex and/or so vague/grey?”

Clients ask the “Why Question” to understand why it can be easy for them to comply with fund marketing regulations in some countries but so difficult in others.

Is the past prologue?

To understand a country’s current fund marketing regulatory regime, it’s always helpful to understand that country’s historic regulatory regime.

Everyone is familiar with the quote from “The Tempest” by William Shakespeare: “What is past is prologue.” This phrase refers to the influence that history has on understanding and contributing to context shaping current events.

When you understand the economic history and cultural influences on the evolutionary development of a country’s fund marketing regulations, you have the context to understand that country’s regulations today.

One of the countries we have analysed with the most interesting regulatory development is Japan.

In this blog, we explore how Japan’s regulations for marketing funds in various structures have evolved over the past two decades, to create contextual understanding of the country’s current regulatory regime.

Importantly, we explore “the power of investor pushback” in the Japan Case Study: how Japan’s powerful pension fund feedback (and pushback) to Japan’s Financial Services Authority has impacted the country’s current fund marketing regime.

Have country fund marketing regulations evolved over time?

Yes. Country fund marketing regulations are different from each other and each country’s fund regulations have evolved at their own individual pace, based on their respective economic and cultural factors.

There is some quasi-standardisation of country fund marketing regulations at EU/EEA level, but each country's regulations – as implemented locally – are not the same due to “top-up” (gold plating) regulations when implementing EU directives locally.

How have Japan's fund marketing regulations evolved over time?

Japan's financial products and services regulations have undergone dramatic evolutionary development in the last 2+ decades. In the late 90s, foreign financial services industry commentary was:

“Japan's fund marketing and licensing rules are so unclear. How can we comply with Japan's fund marketing and licensing regulations when we can't understand them?”

When Japanese-English translation issues surfaced, the challenge for foreign (Western) fund managers to understand Japan's rules increased.

Japan's economic boom and foreign firm response

In the late 90s, confidence in Japan was high: the Japanese government launched its “Big Bang” economic reforms. As a result, there was an increased trend towards non-Japanese (Western) financial institutions who wanted to do business with investors in Japan, a quite lucrative opportunity.

By the early 2000s, Japan's economic recovery had created new millionaires, wealthy Baby Boomers preparing to retire, and foreign firms rushed into Japan (again) to try to crack this difficult but lucrative market. Foreign fund managers, brokers and banks targeted Japanese investors to take advantage of the environment created by the Big Bang, a key economic trigger to Japan's business development. Japan was, in effect, “open for business.”

Japan's economic boom and Japan FSA response

Japan's economy was booming ... but Japan's regulations (especially its fund private placement and licensing regimes) were still under development compared with Western regulatory regimes.

Japan FSA realised it had to act.

The increased business activity by foreign fund managers wanting to conduct business in Japan and with Japan investors rose to a threshold level of capturing Japan FSA's attention.

During that time, our GSC Japan Counsel confirmed that Japan FSA proactively undertook a hiring spree for bilingual Japanese-English lawyers from leading, world-renowned US/UK law schools. It recruited these lawyers under lucrative employment contracts to relocate to Japan and work for Japan FSA.

Similarly, Japan FSA started cracking down on breaches of its financial services regulations by foreign institutions. Several foreign financial institutions were found to be in breach of Japan's securities and licensing regulatory regime and were expelled from the country.

For example, the expulsion of Citigroup Private Bank from Japan in 2004 (and earlier 1999 sanctions against other Citi affiliates resulting in Citigroup affiliate franchise losses) was the most dramatic of a string of failures among foreign firms that have too often misread the attitudes of Japanese investors and regulators.

Powerful investor segment: Japan's pension funds

According to a 2018 survey by a leading global consultant of foreign investment by pension funds around the world,

Japanese retirement assets at that time totalled ¥182 trillion (\$1.2 trillion), making Japan's pension industry one of the largest pension fund markets in the world.

Japan's pension funds face several challenges, including servicing the world's oldest population, low interest rates and sustainability issues. Its pension funds need to diversify its investments in alpha generating opportunities, as the timeline for Japan Pension Funds' Projected Benefits Obligation (PBO), or the total amount that a pension fund expects to pay to meet its future pension obligations benefits to retirees, is increasingly shorter and shorter.

Japan's government cannot afford to not protect its valued pension funds.

Limited partnerships: "light touch" regulation in Japan

Broadly speaking, in Japan, the structure of a fund manager's fund determines which set of Japan regulatory regime applies:

Japan's "Investment Funds Law" (IFL) applies to funds in the form of corporates and trusts and Japan's "New Act" applies to funds structured in the form of limited partnerships (LPs). The new act came into force in Japan in March 2016.

One of the investment vehicle options offered to Japanese investors, including pension funds, is structured in the form of a limited partnership managed by a general partner (GP).

LP regulation in Japan before 2016

Before March 2016, LPs were subject to "light touch" regulations in Japan, so AIFMs (GPs) enjoyed a period of relative ease of regulatory requirements for fundraising from Japanese investors, including from Japan's pension funds. During the "light touch" days, all the GP had to do was file a simple Form 20 and it could conduct business with certain types of investors in Japan. Easy.

It's almost like watching a train wreck in slow motion: "Light touch regulation" when there are trillions of dollars in investor funds to invest outside Japan translates into a lucrative environment for fraudsters to strike. Then scandal hit.

Scandal in Japan: Japanese Ponzi scheme

Several years before 2016, there was a financial scandal whereby a Japanese National created a Ponzi scheme, with operations offshore (outside Japan). It had a "brass plate" office in an offshore domicile. The manager of this scheme was referred to by market observers as "the Japanese Bernie Madoff."

Some significant Japanese pension funds invested in the "Japanese Ponzi scheme," which was structured (some say, intentionally) as a limited partnership so that the scheme could take advantage of Japan's "light touch regulations" for LPs. Major Japanese pension funds lost significant amounts of money in the Ponzi Scheme.

Japan's pension funds, which represent a serious global investor segment, are among the world's largest pools of investable assets, with very short PBO pay-out timeframes. There is no time for getting it wrong.

Investor pushback in action: Pension funds to Japan FSA: DO SOMETHING!

Suffering great losses by investing in this so-called "Japanese Bernie Madoff's Ponzi Scheme," Japan's powerful pension funds acted with pushback to Japan's government and Japan FSA:

You can imagine Japan's pension funds marching into Japan FSA offices with the message, "*DO SOMETHING!*" Change Japan's "light touch" regulations governing limited partnerships so that this never, ever happens again!"

Japan FSA reacted strongly with a 180-degree reversal of regulatory treatment of LPs, from "light touch" to "heavy touch, high-hurdle regulatory requirements" for marketing LPs in Japan. It overhauled regulations and introduced Japan's "New Act," which came into force in March 2016.

Now, compared with other fund structures (corporate form funds and/or trusts subject to the Investment Fund Law-IFL), if GPs want to offer their LPs to investors in Japan, they must comply with a much higher threshold of initial registration requirements, ongoing reporting, disclosures, appointment of a Japan representative in Japan and "special focus" documentation requirements targeted at Japanese Nationals who are GP members, etc. The "New Act compliance requirements list" is extensive and requires much more work to comply with than when LPs enjoyed "light touch" regulatory treatment.

Japan: long-term play (not opportunistic)

In our blog, Fundraising in Japan: A Regulatory Perspective, we made the case that for any fundraising in Japan – especially for GPs offering their LPs to Japan investors – clients should think about Japan as a "Long-Term Play" for fundraising, not an opportunistic "Short-Term Play."

For fundraising in LPs, GPs have a much higher threshold of regulatory requirements to meet: know what you're getting into upfront.

Here are the four key factors which AIFMs/asset managers should consider before starting to fundraise in Japan:

1. Complex fund regulation;
2. Complex licensing regulation;
3. Detail oriented clients (cultural influence); and
4. Regulatory enforcement (punitive sanctions).

Summary

Japan is a lucrative market for fundraising from regulated institutional investors such as pension funds, with \$trillions in assets to invest. But only if you can get the regulations right and are prepared for the long haul.

Knowing the history of regulatory development in Japan can strengthen an AIFM/asset manager's understanding of pension fund investor's buyer behaviour and the context for dealing with them. Once burned, twice shy.

Regulated Institutional investors in Japan do have a say in how their country's fund marketing regulations are drafted. It took the powerful Japan pension fund pushback to close the "light touch regulatory loophole" for LPs.

All National Country Authorities (NCAs) – including Japan FSA – need to protect investors and ensure financial system stability while also ensuring that its investors (especially pension funds) have access to the diversified investment strategies that they need. It's a fine balance that Japan FSA must strike.

After seven years of Japan's New Act in play, it appears that the higher regulatory threshold required by GPs is being met by the fund management industry. For GPs, understanding the background to LP regulation in Japan ("the Why question") is key market intelligence that can help determine whether Japan is a "low hanging fruit" for fundraising focus ... or not.

Never underestimate the power of investor pushback for regulatory change.