

INTERNATIONAL **ASSET** MANAGEMENT
AND **INVESTMENT** FUNDS **REVIEW**
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JAPAN

Facilitating entry into the Japanese asset management industry and investments in non-Japanese alternative assets of Japanese investment trusts

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BIO

Keita Nakano is a partner at Mori Hamada & Matsumoto, which is one of the leading Japanese law firms in the asset management area. He undertakes a broad range of work for non-Japanese investment fund managers.

Keita has been involved in a number of public offerings and private placements of units/shares of investment trusts/corporations established in a variety of jurisdictions, such as the Cayman Islands, Luxembourg, and Ireland, in relation to regulatory and disclosure compliance in Japan.

Also, Keita has advised on the formation and fund-raising of domestic and overseas partnership-type funds, such as private equity and venture capital funds and real estate funds. He has substantial experience in advising general partners and similar entities on contract drafting and regulatory compliance, including filing notifications and discussing with the Japanese authorities in connection with the admission of Japanese investors.

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BIO

Ryosuke Onobori is a senior associate at Mori Hamada & Matsumoto who primarily works in the practice areas of financial regulations, asset management, Japanese real estate investment trusts and capital markets. He specialises in banking, security and payment regulations, and he has extensive experience in advising financial institutions such as banks, asset managers and fintech companies. From 2021 to 2023, he was seconded to the Financial Services Agency of Japan as a deputy director of the Digital and Decentralised Finance Planning Office in the Policy and Markets Bureau. During his secondment, he was actively involved in planning the Japanese regulatory framework for stablecoins, including the development of AML/CFT regulations such as the travel rule, which came into effect on 1 June 2023.

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1. Overview of Recent Regulatory Developments

The Japanese government and the Financial Services Agency of Japan (the "FSA") intend to promote Japan as a "Leading Asset Management Center" and continue to improve the regulatory environment for conducting an asset management business in Japan. For example, in 2023, the FSA established a "Task Force on Asset Management" (the "Asset Management Task Force") to review barriers to the efficient conduct of an asset management business in Japan and published a report (the "Report") to propose measures to address the barriers.

After the publication of the Report, an amendment (the "Amendment") to the Financial Instruments and Exchange Act (the "FIEA") and the Act on Investment Trusts and Investment Corporations (the "ITICA") was submitted to the Diet in March 2024 and promulgated on May 22, 2024. The Amendment includes changes to promote the entry of investment managers, and to stimulate the trading of unlisted securities, which will be effective by May 2025.

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The Japanese government and the Financial Services Agency of Japan (the "FSA") intend to promote Japan as a "Leading Asset Management Center".

In addition, the Japanese Investment Trust Association ("JITA") revised its self-regulatory regulations in 2024, with the aim of diversifying investment targets of Japanese investment trusts. For example, the regulations were amended to (i) clarify the rules for asset managers of Japanese investment trusts to invest in unlisted stocks,

including non-Japanese unlisted stocks and (ii) relax the requirements for investments by Japanese publicly offered investment trusts into non-Japanese alternative funds.

These regulatory updates are expected to stimulate the Japanese asset management industry through, among others, the entry of foreign asset managers and investments in foreign funds.

2. Amendment of the FIEA and ITICA

One of its major objectives of the Amendment is to develop the regulatory regime for the investment management business. It includes changes relating to the sophistication and diversification of asset management, which were made based on the discussions of the Asset Management Task Force and the Report. Specifically, the changes were designed to promote the entry of investment managers and stimulate the trading of unlisted securities, as explained below.

Promotion of Entry of Investment Managers

The Amendment (1) introduced a regime for outsourcing middle and back-office operations (establishing a new voluntary registration regime for middle and back-office operations and relaxing registration requirements for an investment management business that outsources to registered operators) and (2) lifted the prohibition on fully delegating management authority, to address the two challenges to the entry of investment managers: (1) the burdensome requirement for a middle and back-office team, as well as a management team; and (2) prohibiting asset management firms from specializing in fund management functions and outsourcing management (investment execution) – an otherwise common practice in the US and Europe.

Introduction of a regime for middle and back-office operation business

The Amendment established a new business category called “middle and back-office operation business”, which is a type of business that undertakes middle and back-office operations for investment managers. The term “middle and back-office operation business” is defined as a business that conducts any calculation services or compliance services in connection with investment management for a person conducting an investment management business pursuant to the provisions of the FIEA.

The Amendment establishes a voluntary registration regime under which persons engaged in a middle and back-office operation business may be registered under the FIEA. A registered middle and back-office operation business operator is subject to the conduct regulations under the FIEA, including a fiduciary duty to its customers, the establishment of a business management system, and the storage of records.

The Amendment relaxes the registration requirements for investment managers that outsource middle and back-office operations to registered operators. While the FIEA requires investment managers to have officers or employees with sufficient knowledge and the experience necessary to conduct each of its businesses, if an investment manager outsources middle and back-office operations to a registered operator, the Amendment permits them to retain officers or employees to supervise each of its businesses instead. By outsourcing middle and back-office operations to a registered operator, those who want to enter the investment management industry may reduce the burden of having in-house middle and back-office functions.

Full delegation of authority to instruct management

Prior to the amendment of the ITICA and the FIEA, investment trust management companies and investment managers were not allowed to delegate all of their investment management (instruction/execution) authority to another licensed entity.

The Amendment allows investment managers to specialize in fund management functions (planning) and delegate their entire management (instruction/execution) authority to investment managers, provided, that the fund manager sets the management objectives and policies and monitors the investment managers.

As a result, a fund manager may outsource all of its management (instruction/execution) authority and specialize in fund management functions (planning), which contributes to lowering the hurdles for the entry of investment managers.

Stimulation of Trading of Unlisted Securities

In order to promote new entrants into the intermediary business for unlisted securities issued by start-ups and other similar entities, as well as stimulate the trading of such unlisted securities, the Amendment

relaxes the registration requirements for Type I Financial Instruments Businesses (capital requirement, capital adequacy ratios, concurrent business restrictions, etc.) dealing in such unlisted securities, targeting professional investors (specified investors) who, in principle, do not accept customers' money or securities. The term for such Type I Financial Instruments Business under the FIEA is “unlisted securities special intermediary business”, which engages in intermediation activities for specific securities offered to professional investors, and other related activities.

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The Amendment establishes a voluntary registration regime under which persons engaged in a middle and back-office operation business may be registered under the FIEA.

This special regime will be available for Type I Financial Instruments Business Operators which deal with units of foreign investment trusts and shares of foreign investment corporations as these will be included as target securities for an unlisted securities special intermediary business.

The amended FIEA exempts unlisted securities special intermediaries from the capital adequacy ratio regulations, concurrent business regulations, and regulations concerning the provision of financial instruments transaction liability reserves applicable to Type I Financial Instruments Business Operators.

In addition, where securities or money are not deposited, the capital requirement is expected to be lowered from JPY 50 million to JPY 10 million.

Under the FIEA, in order to sell units of non-Japanese investment trusts established and managed by non-Japanese asset management companies and shares issued by non-Japanese investment corporations to investors in Japan, it is necessary to establish a legal

entity in Japan and register as a Type I Financial Instruments Business Operator. This is a major hurdle to selling such financial products in Japan. Through the relaxation of the registration requirements for Type I Financial Instruments Businesses, it is expected that the barriers to bringing investment trusts created overseas to

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In order to contribute to the flow of funds to unlisted companies such as start-ups and provide investors with diverse investment opportunities, JITA revised its regulations to clarify the rules for investment trusts to invest in unlisted shares.

Japan will be lowered.

3. Revision of the JITA regulations

In 2024, the regulations of JITA were revised to (i) clarify the rules for an investment trust to invest in unlisted stocks and (ii) relax the requirements for non-Japanese investment trusts making alternative investments to be included in the trust assets of Japanese publicly offered investment trusts, as discussed at the FSA.

Clarification of the Rules for Investment in Unlisted Stocks

In Japan, there is a need to promote the facilitation of the supply of growth capital and the strengthening of management support by investors for start-ups and unlisted companies to make it easier to establish a business and to increase corporate value. The need to promote the diversification of funding tools for start-ups and unlisted companies is also considered a major issue. Although Japanese investment trusts are not legally prohibited from investing unlisted stocks, it was difficult for Japanese investment trusts to invest in unlisted stocks because the valuation method for unlisted stocks and the appropriate ratio to include unlisted stocks in investment trusts were unclear.

In order to contribute to the flow of funds to unlisted companies such as start-ups and provide investors with diverse investment opportunities, JITA revised its regulations to clarify the rules for investment trusts to invest in unlisted shares. The revised regulations became effective on February 15, 2024.

Under the revised regulations, investments by investment trusts in unlisted stocks should, in principle, be limited to 15% of the total net assets, and the management companies of investment trusts should provide additional disclosures regarding the risks of investing in unlisted stocks, such as the risk of extremely low liquidity, and undertake a review process for investing in unlisted stocks.

After the revision of the regulations, some management companies established investment trusts that invest in unlisted stocks in Japan. Since investments in non-Japanese unlisted stocks are also allowed, it is expected that Japanese investment trusts with an investment strategy to invest in non-Japanese unlisted stocks will be formed, taking advantage of this revision.

Investment of Japanese Publicly Offered Investment Trusts in Non-Japanese Investment Trusts Making Alternative Investments

The relationship between Japanese and non-Japanese investment trusts was discussed at the Asset Management Task Force from the perspective of diversifying investment targets for Japanese investment trusts.

Under the previous JITA regulations, there were many hurdles to the public offering of a Japanese investment trust that invests in a non-Japanese investment trust making alternative investments. For example, JITA, through its self-regulatory rules, prohibited Japanese publicly-offered investment trusts from investing in unlisted non-Japanese investment trusts with borrowings exceeding 10% of its total net assets. JITA also requires that non-Japanese real estate investment trusts and non-Japanese infrastructure investment trusts are listed and their shares are always available for sale to be invested by Japanese publicly-offered fund-of-funds.

As these rules made it difficult for publicly-offered Japanese investment trusts to invest in non-Japanese alternative funds, JITA revised its framework to allow investments in unlisted non-Japanese investment trusts that make alternative investments. Specifically, the JITA regulations added (i) a provision that non-Japanese unlisted investment trusts satisfying standards designated by JITA are exempted from the borrowing restriction and (ii) a provision allowing Japanese publicly-offered fund-of-funds to invest in non-Japanese real estate investment trusts and non-Japanese infrastructure investment trusts satisfying standards designated by JITA. JITA also stipulated the requirements for non-Japanese investment trusts, real estate investment trusts, and infrastructure investment trusts to be included, and the points to note to include them.

According to the statements published by JITA, (i) unlisted REITs, unlisted BDCs, and closed-end funds (including interval funds and tender offer funds) registered with the U.S. Securities and Exchange Commission (SEC) and the states of the U.S., (ii) the European Long Term Investment Fund (known as 'ELTIF') or the UK Long Term Asset Fund (known as 'LTAF'), (iii) UCIs subject to Luxembourg law (known as 'UCI part II') are thought to be able to satisfy the designated standards mentioned above.

Although the requirements subject to these exemptions are limited, new Japanese publicly-offered investment trusts investing in non-Japanese unlisted alternative funds are expected to be formed by considering feasible schemes based on these exemptions.

4. Conclusion

The recent regulatory developments in Japan, including the Amendment and the revision of the JITA regulations, have aimed to facilitate the entry of foreign and domestic asset managers into the Japanese market and diversify the investment targets of Japanese investment trusts, especially in the area of non-Japanese alternative assets. These changes are expected to enhance the competitiveness and attractiveness of the Japanese asset management industry and provide more opportunities and choices for investors and asset managers.

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The relationship between Japanese and non-Japanese investment trusts was discussed at the Asset Management Task Force from the perspective of diversifying investment targets for Japanese investment trusts.

Among the Amendment, (1) the relaxation of registration requirements for an investment management business in connection with the outsourcing of middle and back-office operations will ease the burden of preparing governance arrangements upon the launch of a new investment management business. In addition, with regard to (2) the lifting of the prohibition on the full delegation of investment mandate authority and (3) the easing of entry requirements for financial instruments firms that engage in unlisted securities intermediary services targeting professionals are expected to give flexibility to asset management companies and related financial institutions (distributors).

The drafts of relevant regulations, ordinances and guidelines for the details of the Amendment were published by the FSA on 17 January 2025. The Amendment would provide more preferable regulatory environment from the viewpoint of financial institutions being involved in the Japanese asset management industry.

On the other hand, changes to the JITA regulations, which are already effective as of 2024, have urged asset management companies to form new types of Japanese investment trusts, and it is expected that these updates will develop the Japanese asset management industry with regard to financial products.

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