STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Foreign Hedge Fund Manager Access to Japanese Pension Funds

SBai Toolbox

Introduction

Japanese Private Defined Benefit Pension Funds ("Japanese Pension Funds") are responsible for over USD 750 billion dollars[1] in assets but are subject to strict rules on the ability to make their own investment decisions and the types of businesses that they can allocate to. These rules generally mean that the investment decisions of these Japanese Pension funds are primarily delegated to registered investment managers in Japan.

The registered investment management industry in Japan, however, is relatively small compared to its population and highly concentrated with a small number of firms representing most of the cumulative assets under management. Foreign managers could potentially provide increased choice and competition for Japanese Pension Funds but there are high regulatory hurdles that must be overcome for these investment managers.

This Toolbox memo discusses some of these challenges and looks at potential entry strategies for foreign hedge fund managers including how they compare in terms of licencing and regulatory requirements.

The memo includes:

1. An overview of Japanese Private Defined Benefit Pension Fund market,
2. A comparison of relevant regulatory frameworks in Japan, the US, and the UK, and
3. An overview of access routes for foreign managers to Japanese Pension Funds.

The appendix includes an overview of the current Japan focused investment management industry.

This memo is intended to be information only and should not be relied on as a definitive overview of the licencing and regulatory requirements in Japan.

Overview of the Japanese Private Defined Benefit Pension Fund Market

Generally, unless they are registered to make their own decisions, Japanese Pension Funds are required by law to delegate investment management authority to trust banks, life insurance companies, or discretionary investment managers registered in Japan (collectively "Japan Managers"). This means that foreign fund managers must work with a Japan Manager or obtain a discretionary investment management (DIM) registration to manage Japanese Pension Fund assets.

Japan Managers have been steadily increasing their exposure to international assets and alternatives, currently accounting for over 30% of allocations held through approximately 393 Discretionary Investment

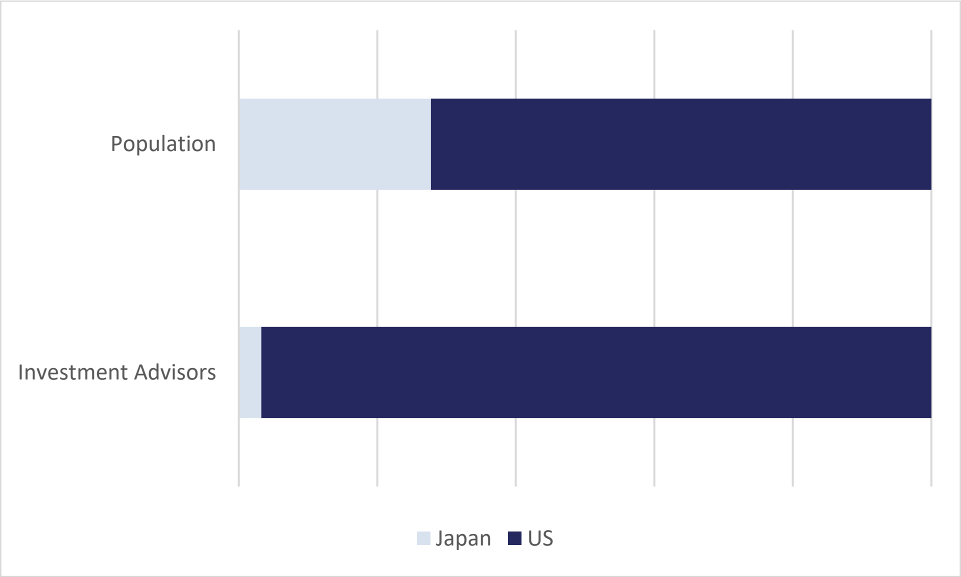
---

[1] https://www.shintaku-kyokai.or.jp/archives/039/202106/20210601-1.pdf

Management (DIM) firms. A large part of this exposure is accessed, directly or indirectly, through foreign asset managers.

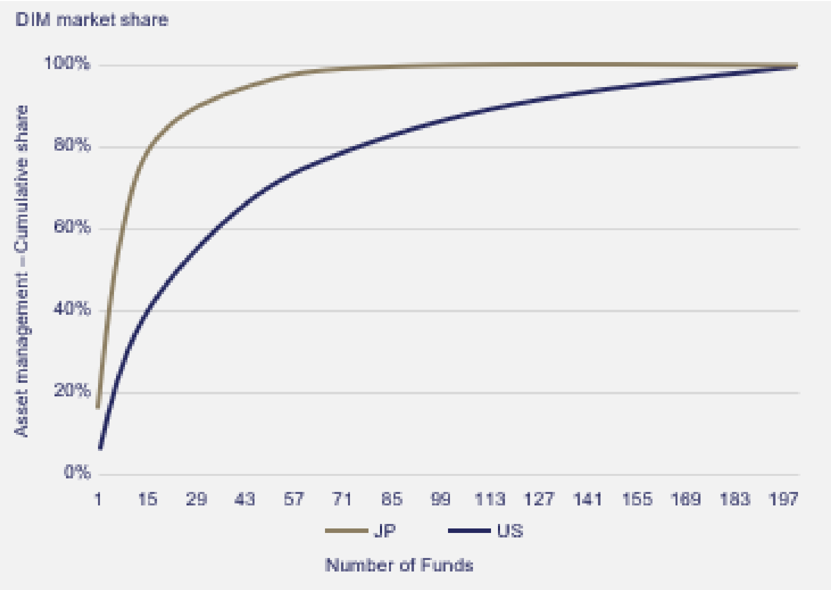
Market Structure:

The Japanese investment industry is less diverse and provides less choice for investors than for example the investment sector in the US. The chart below shows the percentage of the combined total of investment advisers in Japan and the US relative to their populations.



*1. * Number of registered investment advisors. The US number does not include individuals and foreign firms. Number of Discretionary Investment Managers in Japan is 393. Numbers are as of July 31, 2020. Sources: World Bank, FSA, SEC*

In addition, to less diversity in the choice of firms, the Japanese Manager base is also a more concentrated market. The 15 largest Japan Managers account for 80% of AUM. In contrast, the US asset manager environment is broader with the 15 largest managers accounting for approximately 40% of AUM.



2. Japan: Combined AUM of DIM (Pension Newsletter) and Investment Trust (Investment Trust Association) as of July 31, 2020 (including DIM but not Pension Trusts by trust banks). US - "The world's largest 500 asset managers" Willis Towers Watson

As a result of this supply side concentration, Japanese Pension Funds typically do not allocate assets to a large number of Japan Managers. Whilst the number of Japan Managers scales with the size of the Japanese Pension Fund, the average number of allocations has remained constant between six and seven since 2004[2].

Why is the market so concentrated?

There are several possible explanations for this:

- Regulatory barriers both to entry and restrictions on investment decisions by Japanese Pension Funds (discussed further in the next section)
- Japanese Pension Funds may prefer recognised brand names over smaller or newer managers.
- High regulatory and operational costs create barriers to entry for smaller firms, meaning the industry structure may be more accessible for larger firms than smaller firms.

What are the implications?

The structure of the market in Japan raises three important questions on the implications for Japanese Pension Funds and their ultimate beneficiaries:

1. Do Japanese Pension Funds operate in a less competitive market in comparison to pension funds in other markets?
2. Is the service level Japanese Pension Funds receive comparable to service levels in other markets?
3. Do Japanese Pension Funds face higher costs for investment services?

Through the Legal Lens

Regulatory barriers may be one of the reasons for the current market structure in Japan and therefore warrants discussion in this memo. This section provides a comparison of the relevant regulatory frameworks in Japan, the US, and the UK

Key observations include:

- Japanese Pension Funds are subject to rules that require them to delegate the management of their assets to service providers (they retain the right to decide the investment guidelines, determine asset allocation, and select service providers). This is not the case in many jurisdictions outside of Japan. In practice though, smaller pension funds in other jurisdictions do work with registered financial institutions that have the authority to manage the assets of the pension funds even when not legally required to do so.

- As a general point, none of the compared jurisdictions make any distinction in the regulatory treatment between public and private pension funds which both must comply with the same rule to use Japan Managers to make their investment decisions.

Pension Funds Managing their own Assets:

In its infancy in the 1960's, Japanese laws required Japanese Pension Funds to delegate their investments to trust banks and life insurance companies. DIMs were only added to this list in 1990. Prior to this, pressure to open the Japanese market resulted in the establishment of new trust banks in Japan by foreign banks, these turned out to be costly due to lack of scale and operational resources and only

---

[2] https://www.pfa.or.jp/activity/tokei/j-chosa/files/jittaichosa_gaiyou_2019.pdf

one of these remains today. In the mid-90's, the Japanese government further opened the market and the major impediments to Japanese Pension Funds allocating to DIMs were lifted.

The below compares the rules and requirements in the three jurisdictions on pension funds managing their own assets as they stand today:

Japan	US	UK
• DBCPA* requires Japanese Pension Funds to delegate investment decisions to Japan Managers. • By default, most Japanese Pension Funds are classified as "general investors" rather than "professional investors". However, this classification of Japanese Pension Funds may be misleading as many are highly sophisticated with investment experience far beyond the normal "general investor". • DBCPA formally allows Japanese Pension Funds to make decisions on their own but with a numerous and potentially onerous conditions applied.	• There are no regulations in the US that prohibit a US pension fund from managing its own assets. • There is no requirement that a US pension fund engage a US registered investment adviser.	• By default, pension schemes are managed by appointed trustees who may have personal liability, this results in the appointment of fund managers to make investment decisions. • Typically, larger pension schemes (>100 members) use FCA regulated fund managers in line with the statement of investment principles of the pension fund.(Pension funds smaller than 100 members are not regulated by the UK FCA. • In the UK, the fund managers that are appointed by the trustees are generally deemed to be carrying out the regulated investment management and must have relevant regulatory permission.

*Defined Benefit Corporate Pension Act 2019

Japan	US	UK

• There is no specific financial registration that is needed to manage the assets of Japanese Pension Funds and most gatekeepers in Japan are:
    • Registered discretionary investment managers or,
    • Financial institutions that may engage in a discretionary investment management business (e.g. trust banks).
• However, there are certain special rules that apply when managing Japanese Pension Fund assets (for example, not taking instructions from the Japanese Pension Funds).
	• There are no special licenses or registrations required to manage or advise US pension funds.
	• There are an extensive set of additional rules that apply to asset managers that manage funds for pension funds in the US (plan assets).
		• No special licenses or registrations are required to manage UK pension fund assets.
		• Typically, larger schemes will have an FCA regulated fund manager selecting investments in line with the investment principles set out by the scheme's trustees and legislation.

Marketing to Pension Funds:

Outside of general financial promotion rules, only the Japanese market has specific rules regarding securities marketing to pension funds.

In Japan, there are dual governing laws. Pursuant to the Financial Instruments and Exchange Act of Japan (FIEA), the Japan Financial Services Agency (FSA) regulates all financial businesses in Japan including DIMs and under the Defined Benefit Corporate Pension Act (DBCPA) the Ministry of Health, Labour, and Welfare regulates the conduct of Japanese Pension Funds.

The key challenge with marketing is that, as discussed previously, most Japanese Pension Funds do not have the legal ability to make investment decisions. This cause regulatory ambiguity around the type of securities marketing material that can be directed at Japanese Pension Funds. This is compounded further as, in practice, many Japanese Pension Funds make investment decisions as to their target funds (or are at least significantly involved in selection). Due to this, many fund managers may seek to market their fund products to Japanese Pension Funds but are faced with the potential issue of regulatory propriety of marketing securities to a recipient that does not have the legal ability to make investment decisions.

Due to the conflict between the law and practice, many registered securities companies do not actively solicit fund products to Japanese Pension Funds but take the position that they are "sharing information" with the relevant Japanese Pension Fund. Instead, it is commonly accepted that only by registering as a DIM, can a manager directly approach a Japanese Pension Fund for the purposes of securing an investment management mandate – as opposed to the marketing of a fund product.

Access for Foreign Managers

There are many common challenges faced by foreign managers trying to directly provide investment management services to Japanese Pension Funds. These challenges include the relatively higher cost of accessing asset owners in Japan versus other countries. In addition, Japanese Pension Funds may face a dilemma between a desirable risk-taking environment versus the relatively rigid investor protection regulatory framework.

Potential Entry Strategies for Foreign Managers

There are several entry strategies that are open for foreign managers to access Japanese Pension Funds. Each comes with its own benefits and challenges.

Entry Strategy	Benefits	Challenges
Registering as a Discretionary Investment Manager (DIM). *Approximately 15% of companies with DIM registration are foreign companies (60-70 companies)*	Allows direct engagement with Japanese Pension Funds.	Resource heavy with very stringent regulatory requirements. Time taken – the process takes approximately 8 to 12 months to complete.
Foreign Fund Distribution via Type 1 Financial Business Registration *Approximately 10% of companies with this licence are foreign companies (30-40 companies)*	Permits the direct marketing of corporate or trust type funds to Japanese investors.	Securities firms with a Type 1 Financial Business Registration do not typically actively distribute products by non-affiliated companies. Requirements are more rigorous than DIM registration. It can be difficult to independently create access to a wide investor base. Does not permit direct solicitation to Japanese Pension Funds. Time taken – the process takes approximately 12 to 18 months to complete.
Indirect Distribution via Japan Managers *Many foreign managers rely on this method*	The growing need for Japan Managers to offer their customers a range of products that are not aligned with their in-	It is a highly crowded space. There are additional fees for the end investors.

	house investment capabilities means there is high demand for outsourcing to sub-advisors. This is the easiest route from a regulatory and operational perspective for foreign asset managers.	Concerns have been raised over the lack of due diligence capabilities of Japan Managers.

Business Registration Overview

Different types of registrations are required to conduct different types of business in Japan. The legal requirements for registration and the ongoing regulatory requirements vary significantly depending on the category of the business. Generally, the requirements and regulations are most strict for a Type 1 Financial Instruments Business, followed by Discretionary Investment Management Business, then Type 2 Financial Instruments Businesses[3] and lastly Investment Advisory Business.

TYPES OF FINANCIAL INSTRUMENTS REGISTRATIONS	
Type of Financial Instruments Exchange Business	**Type of Financial Instruments Exchange Business Registration**
Distribution/Solicitation of Fund Interests classified as Paragraph 1 Securities (e.g., Units of a Unit Trusts or Shares in a Corporate Fund Structure)	Type 1 Financial Instruments Business
Distribution/Solicitation of Fund Interests classified as Paragraph 2 Securities (e.g., Interests in Limited Partnerships)	Type 2 Financial Instruments Business
Discretionary Investment Management	Discretionary Investment Management Business
Investment Advisory	Investment Advisory and Agency Business
Intermediary/Agency Activity for Execution of Investment Management Agreement or Investment Advisory Agreement	Investment Advisory and Agency Business

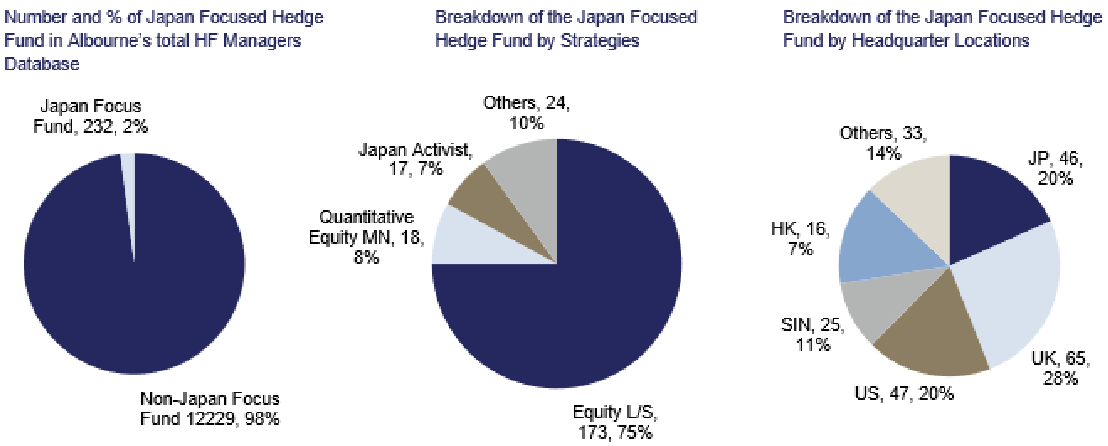
LEGAL REQUIREMENTS				
	Type 1 Financial Instruments Business	DIM Business[4]	Type 2 Financial Instruments Business	Investment Advisory and Agency Business
Personnel Requirements[5]	✓	✓	✓	✓
Minimum Capital/Net Asset Requirements	✓ JPY 50 million	✓ JPY 50 million	✓ JPY 10 million	N/A Deposit of JPY 5 million

[3] Type 2 Financial Instruments Business covers self-offering of certain Paragraph 1 securities such as the units of an investment trust fund where the Type 2 Financial Instrument Business is also acting as the Investment Trust Manager.
[4] There is a sub-set of the Investment Management Business Registration called Pro-DIM (Investment Management Business for Qualified Investors). The requirements for Pro-DIM are less stringent than the Full-DIM e.g., the Minimum Capital/Net Asset requirements are JPY 10 million, there is no requirement to have a board of directors, and the compliance function can be delegated to outside professionals.
[5] The necessary personnel composition of each business needs to be carefully considered based on the type of business performed, the content of the financial products handled, the scale of transactions etc.

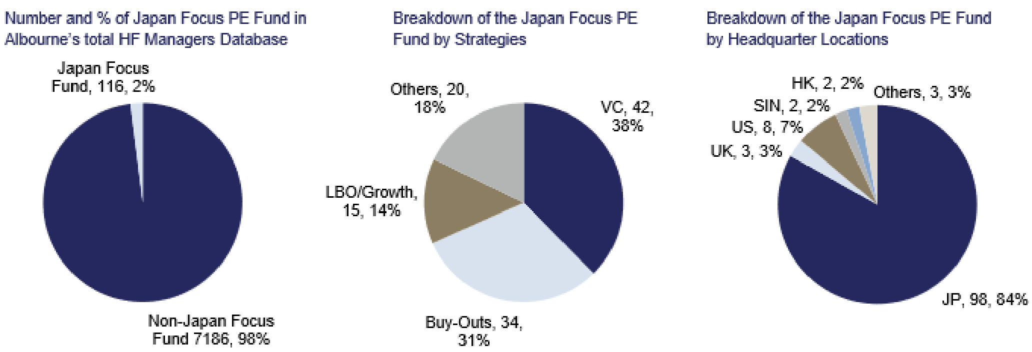
Must be a KK[6] or branch of a KK equivalent company	✓ Requires Board of Directors and Statutory Auditor	✓ Requires Board of Directors and Statutory Auditor	N/A	N/A
Limitations on Side Businesses	✓	✓	N/A	N/A
Major Shareholders Requirement	✓	✓	N/A	N/A
Minimum Capital Adequacy Ratio	✓ 120% or more	N/A	N/A	N/A

Appendix A: Overview of Japanese Hedge Fund Market

Most Japan focused hedge fund managers operate equity strategies and have headquarters that are globally diversified.



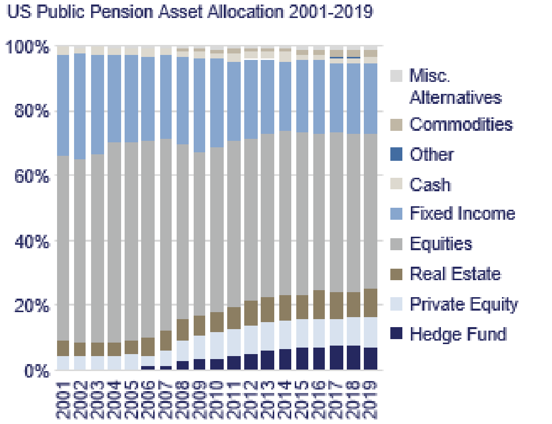
Most Japan focused private equity managers are based locally in Japan.



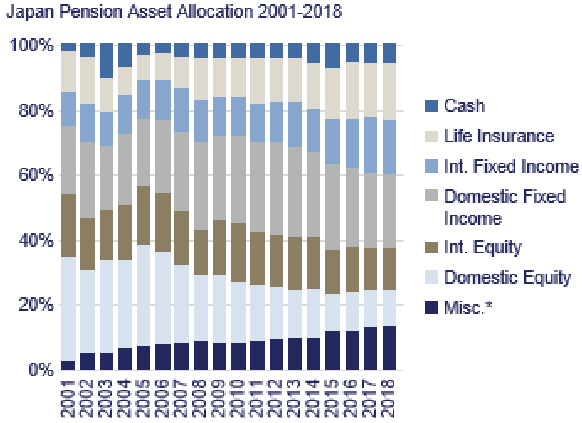
Public Pension Asset Allocation: US vs Japan

Both Japan and US pension funds' allocation to alternative asset have steadily increased for the past 20 years.

[6] "Kabushiki Kaisha", commonly abbreviated KK, is a type of company defined under the Companies Act of Japan



According to the U.S. Census Bureau, roughly 6,000 public sector retirement systems exist in the U.S. Some of the 299 state-administered plans and 5,977 locally-administered plans date back to the 19th century and each has evolved independently. Collectively, these plans have $4.3 trillion in assets.



In Japan, there is a total 1066 Pension Funds

Mean participant size: JPY276.7bn

Median participant size: JPY31bn

**Misc. includes hedge fund, private equity, and real estate*

Appendix B – SBAI Japan Working Group Members

The following firms contributed to the production of this Toolbox memo as part of the SBAI Japan Working Group

Albourne Partners Japan

Dymon Asia Capital Japan

Mitsui & Co. Pension Fund

Tasku Advisors

Withers Law Offices Japan