



## **Issues and recommendations concerning the sale of offshore funds in Japan**

### **European Business Community in Japan (EBC)<sup>1</sup>**

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#### **1. Proposed changes to the taxation of investment trusts**

It is widely understood that the Ministry of Finance (MOF) is considering changing the way investment trusts are taxed in Japan, to the disadvantage of offshore products.

The changes proposed by the MOF are as follows:

1. The tax rate for capital gains on transfer for both onshore and offshore funds will be increased from 0% to 26% starting 1 January 2004
2. The tax rate on income from dividends for both onshore and offshore funds will be decreased from 20% to 10% for 4 years starting 1 January 2004 (through to 31 March 2008)

Even though the proposed tax rates are supposed to apply equally to both onshore and offshore funds, a significant difference in the amount of tax fund holders pay is likely to emerge depending on the way in which they exit a fund.

Investors in offshore funds are only allowed to use the “repurchase” method to liquidate their holdings, whereas investors in onshore funds can choose between “repurchase” and “redemption”. Profit derived from a repurchase is regarded as a capital gain whereas profit derived from redemption is regarded as income. Investors in onshore funds will naturally choose “redemption” to benefit from the lower tax rates. This option is not

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<sup>1</sup> The European Business Community is the trade policy arm of the combined European national Chambers of Commerce in Japan.

available to investors in offshore funds, and, as a result, there is a serious risk that investors in offshore products will pay considerably more in tax than investors in onshore funds. This would clearly discriminate against offshore products and reduce the options available to Japanese investors.

Administering these proposed changes would also introduce complications in establishing the cost for each investor for purposes of determining the amount of capital gains and income tax due.

Recommendations:

The EBC urges the Ministry of Finance to harmonize both income and capital gains taxation rates between onshore and offshore investment products. Further we seek the application of identical fund liquidation criteria to both onshore and offshore products to ensure equality of treatment between onshore and offshore funds.

**2. Regulations governing the sales, service and marketing of offshore funds in Japan:**

Asset management firms licensed to provide investment advisory services and/or manage investment trusts in Japan are currently required to take out a side-business license from the Financial Services Agency (FSA) and Kanto Financial Bureau (KFB) to support the sale, marketing and service of offshore funds managed by group affiliates.

Most of the side-business licenses issued by the FSA/KFB for this purpose have been limited in scope to such activities as providing marketing support to the group head office, customer support in areas such as document translation, and in some cases allowing firms to introduce existing or potential clients to group affiliates.

It is generally understood that the scope of these licenses does not allow for firms to take a more active role in developing product presentation materials and presenting this material on behalf of overseas affiliates to existing or potential clients in Japan. It is also unclear how active a firm may be in actively seeking new business, answering client enquiries, and providing regular reporting services regarding the products of overseas affiliates.

The FSA/KFB has been reluctant to define and disclose the types of side-business applicants may conduct. Different firms have received different authorization depending on the scope of the application submitted, even though underlying business objectives do not differ substantially between firms. This lack of regulatory consistency calls into question the supposed

neutrality of the regulatory environment and makes it difficult for firms pursue new business opportunities for fear of non-compliance.

The current rules governing the support, marketing and distribution of offshore funds have not completely prevented the sale of such products to either Japanese institutions or Japanese individuals. It is widely recognised that many offshore products have been bought in Japan that resulted from the sales and marketing efforts of unlicensed entities in Japan. Given that such products can and have been bought by Japanese investors, the EBC feels that the Japanese Government should recognise this fact and move to widen distribution channels whilst ensuring adequate and correct disclosure of such products.

Ultimately, it is the product originator (and its affiliates) that knows its own products best and should be held responsible for the accuracy of information provided to existing/potential clients. The use of third party distributors with a domestic broker licence means that communication is at best second hand and that the product originator is reliant on a domestic counter-party to sell the product correctly. We believe that the risk to the originator's reputation is greater when its local affiliate is not allowed to play a full part in the sales and marketing process. We also feel strongly that it would be preferable for most buyers of offshore products to be able to address concerns in their own language to the local affiliate of the product originator.

At the same time, the EBC feels that it is inappropriate to ask licensed asset management firms to take out a securities license in order to fully support the sales of products managed by off-shore affiliates. Asset management firms are not brokerages and should not be regulated as such. The fact that very few asset management firms have applied for securities licenses indicates their reluctance to take on the additional burden associated complying with two completely different sets of regulatory requirements.

*Recommendations:*

1. The EBC feels that in principle the promotion of products managed by overseas affiliates constitutes a part of an asset manager's core business and that a common set of rules governing the promotion of offshore products should apply to all investment advisory firms already licensed to do business in Japan with no need to apply for an additional license to do business in this area. This reform would result in more product choice, more pooling of assets and therefore greater economic efficiency.
2. The EBC recognizes that most foreign asset management firms have already received (or are in the process of applying for) a side-business

license to support the marketing of products managed by overseas group-affiliates and recommends that as a first step improvements be made to the current side-business licensing system to make it easier for firms to support the sales and marketing of products managed by overseas group-affiliates to professional institutional investors in Japan.

In particular, the EBC recommends the following:

- a) The FSA/KFB should clearly define the scope of the side-business license for the business support of affiliated-offshore products and apply these criteria equally to all firms that make an application.
- b) The license should explicitly allow for the following activities:
  - i. Introducing existing or potential clients<sup>2</sup> to group-affiliated companies<sup>3</sup> of the license holder. License holders should be able to a) develop sales and representation materials in Japanese for group-affiliated products based on information provided by the group affiliate and b) present this material on behalf of the group affiliate to existing or potential clients.
  - ii. Providing client services on behalf of group-affiliated companies. This should include a) liaison services between potential/existing clients and group affiliates in terms of any inquiries, requests and responses via fax, e-mail, telephone, video conference and any other communication tool, and b) regular reporting to existing clients.
  - iii. Providing market research and marketing support to group-affiliated firms for a fee.
3. If the Japanese Government has legitimate concerns about cross-regulatory co-operation, we recommend that the FSA establish a list of offshore jurisdictions with whom close ties exist and whose products would pass similarly stringent requirements.

### **3. Regulations governing the structure and content of feeder funds in Japan:**

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<sup>2</sup> Specifically, fund distributors such as securities firms and banks, and qualified institutional investors defined in the Securities Exchange Law.

<sup>3</sup> Specifically, companies that have a majority interest or that share a majority shareholder with the applicant.

Japan Investment Trust Association rules stipulate that funds can only invest up to 5% of their net assets in other funds. This rule, however, does not apply to so-called “fund of funds” or to “baby funds” or “feeder funds” investing in “mother funds”. Funds of funds are allowed to invest 100% of their assets into other funds as long as they invest in at least two funds. A baby fund can invest in a single mother fund so long as the mother fund is managed by the same fund management company. Since offshore funds managed by group affiliates do not qualify as a mother fund under this definition, this regulation in effect prevents onshore feeder funds from investing wholly in an offshore vehicle.

From a product provider perspective, these impediments:

- Prevent sensible pooling of investment assets to take advantage of economies of scale, thereby increasing fund management costs;
- Lead to increased administration expenses, with many more Net Asset Value (NAV) calculations being performed;
- Give rise to far too many “me too” mutual funds on the market, most of which are too small to be commercially viable for either distributor or product provider;
- Prevent asset management firms from effectively using their global capabilities to promote their clients’ interests in Japan.

From an investor’s perspective, these impediments:

- Restrict choice and access to interesting offshore products;
- Increase the cost of onshore investment products that result from high expense ratios associated with the management of a large number of small, uneconomical funds.

*Recommendations:*

The EBC urges the Japan Investment Trust Association to amend the regulations governing mother-baby funds to allow offshore funds managed by group affiliates to act as a mother fund, thus making it possible for onshore feeder funds to invest wholly in a single offshore vehicle.