

This article originally appeared in the December 2005/January 2006 issue of *Fund Management*.

Hedge Fund Focus

Hedge Funds Increasingly Target Japan

Christopher P. Wells
White & Case



Christopher P. Wells
Partner

As Japan continues to undergo broad social, economic and legislative changes, foreign alternative investment funds are flocking to the country to take advantage of new opportunities. But they also are facing new challenges.

Alternative funds operating in Japan can, for convenience, be categorized into two principal groups. First, there are offshore fund groups seeking to raise capital in the Japanese market for investment outside the country. We can refer to this segment as the “outbound” market. Second, there are fund groups, both domestic and foreign, utilizing foreign capital to pursue Japanese domestic-market investment strategies in the hedge fund, private equity, venture capital and real estate markets. We can refer to this segment as the “inbound” market.

Opportunities

Several key factors are creating investment opportunities for outbound and inbound funds in Japan.

On the inbound side, opportunities are strong in part because of a widespread desire among US institutional and European investors to increase their exposure to the country during what is perceived as a rising Japanese economy. For example, Japan’s roughly \$4.7 trillion GDP has expanded

steadily, consumer spending and corporate profits are rising, while the Nikkei 225 index is up almost 20 percent since early this year. Exports are rebounding and the mountain of Japan Inc.’s corporate debt is dwindling. There have even been murmurs that the Bank of Japan may move toward ending its longstanding easy monetary policy as deflation fades.

On the outbound investment side, there is a marked need among Japanese institutional investors, pension funds and insurers to increase returns to meet demanding funding requirements for future liabilities.

The challenge of funding pensions is particularly severe in Japan, because of several factors, including demographics: the population is expected to decline from 130 million to 100 million by 2050, so a proportionately small number of workers will be servicing pension liabilities for a large graying population. To meet this challenge, benefit cuts and higher premiums are being introduced, but this will only take the pensions so far. Getting better returns through investment in international markets has become a necessity.

Moreover, Japan’s old “keiretsu” system—a chain of corporate alliances based on cross-shareholdings—has been breaking down, facilitating introduction of “shareholder value”—type alternative investment

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strategies. During 2005, this has been the hottest strategy, with hundreds of millions of dollars pouring into the space.

In sum, alternate funds are attracting global institutional investors as a result of the dearth of more traditional investment options and the weakening ties of domestic corporate structures. Moreover, the decision in Japan's September lower house election, which was waged on the issue of Postal Privatization, made clear that in coming years the huge surplus of Postal Savings and Postal Pension assets hitherto used to fund government social programs, will increasingly enter the international investment space.

The resulting potential flood of investment in global markets is probably between five and ten years away, but it has significant implications for managers in the alternative investment space, because it promises to provide a continuing source of investment assets, as US and European movement into the alternative space moderates over the next few years.

Two Areas of Growth

Hedge fund growth has been driven not only by a resurgent economy and institutional demand for better returns, but also by the development of a more sophisticated fund platform infrastructure in Japan.

Estimates of how much money is flowing into hedge funds targeted at Japan typically range from about \$20 billion to \$25 billion. A high percentage of these assets—up to 85 percent, by some estimates—is invested in equity long/short strategies.

As for the distribution of hedge funds by size, a little more than half of all Japan-directed funds currently have assets under management of between zero and \$50 million. About 6 percent exceed \$500 million, with the rest falling in-between. Particularly interesting about the largest funds is that most of them are now closed to new investment and have capacity constraints on their deliverable performances. In fact, in Japan there is a significant concentration in invested assets in the larger funds and many newly launched funds have hit the \$100 million mark within 12 months of launch.

Interest in Japan has been sufficiently great that the capital-raising process has been accelerating, with the best managers often soft closing within six to 18 months. However, it also appears that new launches may be easing, with the first eight months of this year showing a markedly slower period of activity compared with the same period in 2004. The main reason for this slowing may be a shortage of talented managers rather than strategy capacity. This factor is viewed by investors as the most serious constraint on the growth of the industry.

Overcoming Regulatory Hurdles

For Japan-focused funds on the inbound side, as long as fund managers remain offshore while directing fund entities also outside Japan and capitalized by foreign money, there are few regulatory issues. However, establishing an onshore presence to direct a Japanese market strategy can be an expensive undertaking and burdensome project from a regulatory perspective.

Those on the outbound side that want to tap the huge pool of Japanese capital that will be coming online over the next decade should move carefully to develop links and presences in the Japanese market—there are limits to the level of access one can gain by merely flying in marketing professionals with flip-charts. However, the possibility of being found to have engaged in systematic illegal solicitation of Japanese investors is also very real, especially where one is successful at raising large volumes of funds. Japanese regulations governing solicitation of Japanese investors, although weakly enforced, are as restrictive as those of the United States (upon which they are based) and require careful attention from a compliance perspective. And Japanese regulators are becoming more proactive in enforcement.

Last year, the Japanese Diet provided a low-cost solution in the form of a "securities sales intermediary" registration. This is the preferred license for offshore fund groups that wish to market to Japanese institutional investors or to work with a Japanese distributor to gain access to high net worth individuals. For firms willing to make the investment in a responsible local presence, the payoff can be substantial. The possibility of capital raises in the billions of dollars is certainly not out of the question.

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For the “inbound” investment group, Japan’s Investment Advisory Business Law is simple and direct in its coverage: those who give investment advice concerning the purchase or sale of securities from a Japanese base for compensation must register with the Financial Services Agency (FSA) as an investment advisor in Japan. Most foreign investment banks managing Japanese money also have so-called “protective” investment advisory registrations for their foreign affiliated investment advisers.

On the other hand, if you want to manage money directly in Japan through a local office, under the Investment Advisory Business Law, you will need a second-level license known as a “discretionary investment advisory” (DIM) license. Without such a license, managers cannot have material interaction regarding the purchase or sale of securities on behalf of the fund pools they manage from a Japan base. Unfortunately, obtaining this license is time-consuming, costly, requires significant local resources and subjects the fund manager to an increased level of regulatory scrutiny.

Other Challenges

Although it has never been easier to set up as a fund manager in Japan (since the start-up hedge fund path is pretty well established and most service providers are fairly sophisticated about the needs of new funds), managers and traders can expect several challenges when coming to Japan to launch a fund.

Established managers considering coming to Japan to raise funds should first consider whether they can get funding through intermediaries at a reasonable cost. Raising capital in Japan is different than in other jurisdictions, in that Japanese clients require a great deal of “after-care.” Typically, intermediaries specializing in capital introduction already have an established relationship with the funding party and are expected to be accountable for the offshore

funds that they introduce to the firms. They can also serve as a “buffer” with the client from a Japanese regulatory perspective.

Managers who believe they must have a presence in Japan should avoid doing it by halves. They should have signed on a well-known and successful portfolio manager who is known to the target investors. In addition, several investors should confirm they will place a target minimum amount with the fund (at least \$10 million for the Tokyo market). Another asset is to have a strong, and hopefully longstanding, relationship with a prime broker and administrator, as well as professional advisors—lawyers, accountants, and so forth.

Managers should also know how to cut their losses. Japanese presences are expensive to establish and even more expensive to maintain. An exit scenario should be available in case things do not work out. Most managers, however, currently believe that the new interest in, and demand for, alternative investment in Japan will sustain them for the foreseeable future.

Christopher Wells has worked as a lawyer in Japan for more than 20 years. His practice is focused on financial regulatory, investment fund, securities, banking and general corporate matters. In addition to his practice at White & Case, Wells has been the Chair or Co-Chair of the Financial Services Committee of the American Chamber of Commerce in Japan since 1998.

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