

On the basis of the introduction of the “Independent Agent Exemption” in the FY2008 Tax Reform, the Financial Services Agency has compiled the Q&A below regarding questions about the practical application of the legal independence concept in determining whether a Domestic Investment Manager* conducting Certain Investment Activities under a Discretionary Investment Agreement (DIA) with an Offshore Fund is treated as an “Independent Agent”

The basic features of the funds, conditions of the management entrustment and the remuneration in this Q&A are basically based on the same assumptions as the reference cases of the “Determination of whether a Domestic Investment Manager conducting Certain Investment Activities under a Discretionary Investment Agreement with an Offshore Fund is treated as an ‘Independent Agent’” which is compiled separately.

Different consequences may result if the facts and circumstances differ from those assumed herein or if the relevant laws and regulations are changed.

Regarding this Q&A, the FSA has asked for the National Tax Agency’s views, and the NTA notified the FSA that it has no objection to its contents.

* a person registered under Article 29 of the Financial Instruments and Exchange Act (FIEA) to carry out an invest management business prescribed in Article 28 (4) of the FIEA (limited to business in respect to the Discretionary Investment Agreement (Article 2 (8) (x ii) (b) of the FIEA)) (including a person approved by the commissioner by the FSA according to the Article 16 (x vii) of the Cabinet Office Ordinance on Definitions under Article 2 of the Financial Instruments and Exchange Act)

Main Text

Q&A for the Legal Independence in determination of whether
a Domestic Investment Manager is treated as an Independent Agent

(Basic Concept)

Investment Decisions which a Domestic Investment Manager is fully or partly entrusted by a Foreign General Partner or a Foreign Investment Manager under a DIA are “decisions on the kinds, issues, amounts or prices of securities to be invested as well as whether the securities shall be purchased or sold and by what method and at what timing, or decisions on contents and timing of derivative transactions to be conducted”. In determining Legal Independence of an Independent Agent, it is important that the Domestic Investment Manager has enough discretion to make these decisions when acting as an agent.

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【Q1 – Risk Management】

In cases where a consignor (meaning a Foreign General Partner of an offshore fund or a Foreign Investment Manager ; the same shall apply hereinafter) may give and is actually (and frequently) giving the following types of instructions on risk management to a Domestic Investment Manager under a DIA, are those considered as “detailed instructions”?

(Example 1) The consignor may give appropriate instructions on limitations of risk amount in accordance with the market circumstances (instead of prescribing such limitation as a numerical value or calculation formula in the DIA) . If the Domestic Investment Manager manages the assets exceeding the specified risk limitation amount, the consignor may instruct the Domestic Investment Manager to promptly liquidate the position.

(Example 2) The consignor may give appropriate instructions on limitations of risk amount in accordance with the market circumstances (instead of prescribing such limitation as a numerical value or calculation formula in a DIA) . Under unusual market circumstances (such as the recent subprime loan crisis) , the consignor may instruct the Domestic Investment Manager not to apply certain management methods.

(Example 3) The consignor may give appropriate instructions on limitations of risk amount in accordance with the market circumstances (instead of prescribing such limitations as a numerical value or calculation formula in a DIA) . If the liquidity of a certain stock in the portfolio of the fund becomes extremely low, and if the consignor considers that the amount of assets invested in such stock is relatively large compared with total asset under management, the consignor may instruct the Domestic Investment Manager to promptly liquidate the position in the stock.

【Answer】

In administrating and managing a fund, it is often found that investment of the assets under management is entrusted to experts (i.e. invest managers) in various regions / fields, while the management of risks associated with such investments is concentrated to a particular person. Instructions on such risk management (limitation of risk amount) are not normally considered as “detailed instructions” which negate enough discretion of a Domestic Investment Manager to make investment decisions, even if the consignor, who “may give appropriate instructions in accordance with the market circumstances” under the DIA, may give and is actually (and frequently) giving such instructions to the Domestic Investment Manager. This is because such instructions, as described in Example 1 and 2, are not normally ones on “kinds, issues, amounts or prices of securities to be invested as well as whether the securities shall be purchased or sold by what method and at what timing”.

However, if the instructions on risk management are given on individual issues of securities or the timing of purchases or sales of particular securities as in Example 3, such instructions may negate enough discretion of the Domestic Investment Manager to make investment decisions, and accordingly, may be considered “detailed instructions”.

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【Q2 – Asset Allocation】

In cases where a consignor may give appropriate instructions on asset allocation in accordance with the market circumstances (instead of prescribing such allocation as a numerical value or calculation formula) under a DIA and is actually (and frequently) giving the following types of instructions, are those considered as “detailed instructions”?

(Example 1) Instructions on the ratio of bonds and shares

(Example 2) Instructions on the ratio of industry types in shares investment

(Example 3) Instructions on the ratio of specific issues of securities

【Answer】

Under a DIA, it is quite common for the consignor to specify asset allocation. General instructions on asset allocation as described in Example 1 and 2, which do not negate enough discretion of the Domestic Investment Manager to make investment decisions, are not considered as “detailed instructions”. This is because such instructions are given on the kinds of securities to be invested, but not on “issues, amounts or prices of securities to be invested as well as whether the securities shall be purchased or sold and by what method and at what timing”.

However, if the instructions on asset allocation are given on the ratio of specific issues of securities as in Example 3, such instructions may negate enough discretion of the Domestic Investment Manager and accordingly, may be considered “detailed instructions”

【Q3 – Investment Restrictions (Negative Lists, etc.)】

In cases where a consignor may give and is actually giving the instructions which prohibit a Domestic Investment Manager from investing in certain industries or issues of securities under a DIA, are those considered as “detailed instructions”?

【Answer】

Under a DIA, the consignor sometimes prohibits investment into certain industries or particular issues of securities for various reasons. Such instructions on investment restrictions refer to particular issues of securities to be invested, but are not considered as “detailed instructions”. This is because such instructions do not negate enough discretion of the Domestic Investment Manager to make investment decisions in securities other than of prohibited industries or issues.

【Q4 – Investment Policy】

In cases where a consignor may give and is actually giving the following instructions under a DIA, are those considered as “detailed instructions”?

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(Example 1) consignor and the Domestic Investment Manager periodically hold investment committee, and the Domestic Investment Manager makes investments in line with the investment policies decided by the committee.

(Example 2) consignor's approval is required for a material change in the investment policies (for example, to change investment asset class from "listed shares only" to "listed shares or unlisted shares")

【Answer】

Under a DIA, it is quite common for a consignor to establish an investment policy which, for example, limits investment asset class to listed shares, etc., (or to approve changes of such investment policy). General instructions on an investment policy (or approvals on changes of the investment policy) as described in Example 2, which do not negate enough discretion of the Domestic Investment Manager to make investment decisions, are not considered as "detailed instructions". Such instructions are given on the kinds of securities to be invested, but not on "issues, amounts or prices of securities to be invested as well as whether the securities shall be purchased or sold and by what method and at what timing".

Similarly, in cases where a consignor and a Domestic Investment Manager jointly hold an investment committee where they determine an investment policy as in Example 1, such investment policy is not considered as "detailed instructions" as long as it is a quite general policy, which does not negate enough discretion of the Domestic Investment Manager to make investment decisions.

【Q5 – Investment Approvals】

In cases where a consignor's approval is required under a DIA to invest more than a certain amount in a particular issue of security and in fact the consignor grants such approvals, are those considered as "detailed instructions"?

【Answer】

Approvals for investments of more than a certain amount into a particular issue of security may be considered as "detailed instructions" which negate enough discretion of the Domestic Investment Manager to make investment decisions, as those are given on the particular issues of securities to be invested.

【Q6 – Information Exchanges】

In cases where a consignor and a Domestic Investment Manager exchange information on market circumstances and analysis/outlook related to a particular issue of security, are those considered to undermine the Legal Independence of the Domestic Investment Manager?

【Answer】

The English translation is made only for reference. In case of any discrepancy between the Japanese original and the English translation, the Japanese original shall prevail.

Even if a Domestic Investment Manager provides substantial information to consignor in connection with the investment activities under the DIA, this does not in itself constitute a sufficient factor to determine that the agent is dependent, unless the information is provided in the course of seeking approval from the consignor for the manner in which the investment activities are to be carried out. The provision of information which is simply intended to ensure smooth implementation of the agreement and continued good relations with the consignor will not undermine the legal independence of the Domestic Investment Manager.

However, if a consignor gives instructions on “issues, amounts or prices of securities to be invested as well as whether the securities shall be purchased or sold and by what method and at what timing” in the course of exchanges of information or views, such instructions may be considered as “detailed instructions” that negate enough discretion of the Domestic Investment Manager to make investment decisions.

【Q7 – Oversight】

In cases where a Foreign Investment Manager, an agent, oversees a Domestic Investment Manager, a sub-agent, as to, for example, whether the Domestic Investment Manager complies with the DIA, does such oversight undermine the Legal Independence of the Domestic Investment Manager?

【Answer】

It is frequently found that a Foreign Investment Manager, to whom an offshore fund entrusts the management of the fund, re-entrusts part of such fund management to experts (invest managers) in various regions / fields. In that case, the agent (the Foreign Investment Manager) is responsible vis-à-vis the principal (the offshore fund) for the appointment and supervision of such sub-agent (the Domestic Investment Manager) and accordingly, oversees the sub-agent (the Domestic Investment Manager). Since the Foreign Investment manager performs such oversight in the course of fulfillment of its duty to the principal to act with the care of a good manager and it is simply an oversight on compliance with the agreement, etc., such oversight does not undermine the Legal Independence of the Domestic Investment Manager.

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