Financial Services Forum
White Paper

Reimagining Japan as a Global Financial Center

Create a globally leading financial center that will drive long-term economic growth

The American Chamber of Commerce in Japan

Published by:
The American Chamber of Commerce in Japan
Masonic 39 MT Bldg. 10F
2-4-5 Azabudai
Minato-ku, Tokyo 106-0041 Japan
Tel +81 3 3433 7358
Fax +81 3 3433 8454
external@accj.or.jp
www.accj.or.jp

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INTRODUCTION

The American Chamber of Commerce in Japan (ACCJ) fully supports the recently re-energized efforts, both by the national and Tokyo metropolitan governments, to reestablish Japan's position as a preeminent global and regional financial center. We believe it is imperative that Japan's standing in global finance more fully reflect the tremendous scale of its economy and investment capital. We further believe that adopting policies to achieve success in this effort is an important step for Japan to return to sustained and strong economic growth.

National government commitment in this endeavor is critical, as certain resources and policies required for success can only be achieved with central government action. We are encouraged by the recent focus on this effort by the administration of Prime Minister Suga and the JFSA, which greatly enhances prospects for sustained success. We appreciate the many recent signs of progress as well as the constructive approach of the government in working with the finance industry on this important initiative.

As the topic of revitalizing Japan's stature as a financial center has gained greater attention during the past year, a wide spectrum of views has emerged on how best to achieve this goal. Many of these views have focused primarily on incentives designed to attract new businesses and skilled individuals to Japan. Examples include tax breaks, greater use of English for conducting official business and assorted quality-of-life enhancements believed to be important to foreigners.

Incentives such as these have been advocated previously by the ACCJ and other organizations, and they are important for the success of the financial city plan. However, we believe they are likely to prove insufficient on their own. To produce durable and compounding success over the long term, a number of more structural policy measures must also be implemented.

In other words, while certain tactical incentives are needed initially to draw talent and new businesses into the Japanese market, delivering on the more structural areas described in this paper is vital for ensuring that the talent and new businesses remain here in an environment where they can grow, profit and innovate sustainably.

The case for Japan to become a more robust, innovative, and globally relevant financial center goes far beyond seizing the opportunity that has opened up recently as competing regional centers have become less compelling. The fact is, relative to the size and diversity of its economy, Japan's finance industry punches far below its weight.

One simple global comparison, focused solely on institutional capital markets, provides an insightful example: Looking at the sum of equity issuance, debt issuance and total M&A volume (both domestic-only and international) as a percentage of 2019 GDP, Japan stood at just 9% compared with 16% for the US, 14% for Europe, and 11% for China. Simply getting to the average of 14% would imply a 50% increase in capital market size and nearly $250 billion of additional capital markets activity annually for the Japanese market—and this does not include upside from fintech and other myriad ancillary businesses that would also benefit from a scaled-up industry.

Examples such as this suggest that Japan's financial ecosystem has the potential to contribute much more to the economy than it currently does. A comprehensive financial center revitalization plan could help realize this potential by contributing to growth in high-quality jobs, drawing foreign know-how and investment into Japan and improving returns on pension and personal investment portfolios as asset management and governance standards improve.

Lastly, as the circulatory system of any economy, the financial sector has an important role to play in achieving full growth potential and for ensuring financial stability in a rapidly aging society. Seen in this light, we believe that the creation of a world-class financial ecosystem is an important step for achieving the government of Japan's (GOJ) broader growth, sustainability, and innovation agenda.

The recommendations in this white paper on the tactical and structural policies for achieving a more robust financial ecosystem are based on the need for improvement in the following areas:

- **Make it easier to live and work in Japan, as well as to enter and return**
  For finance professionals considering working in Japan as individuals or as business owners, there remain a range of obstacles and friction points adversely affecting quality of life and ease of entry. Further progress on addressing these will enhance prospects for attracting and retaining talent.
- **Improve governance, transparency, and stewardship**
  Japan's relative underperformance as a global financial center is due in significant part to corporate governance, transparency and fiduciary standards that must be further improved for Japan to compete effectively with other leading financial centers.
- **Address the need for more specialized professionals**
  A related but distinct issue is the relatively shallow pool of financial and other professionals with world-class expertise and sophistication, especially in key areas of asset and pension management—long-only equity, private equity, hedge funds—but also including the already-burgeoning need for qualified and well-trained Japanese and non-Japanese independent directors, and emerging areas such as fintech.
- **Broaden market participation among individual investors**
  It remains universally acknowledged that investment asset allocation among Japan's savers is wholly inadequate to meet the long-term financial requirements of the society. It is therefore vital to create conditions for more efficient allocation to deliver higher long-term risk-adjusted returns.
- **Address shortcomings in selected financial regulations**
  While good progress has been made in recent years, there remain several key areas of financial regulation in need of modification to spur innovation and increase efficiency to levels comparable with other leading financial centers.
- **Facilitate development of key financial infrastructure functions**
  Institutional capital markets and fintech are two infrastructure areas particularly deserving of attention. While certain segments of institutional trading are among the most liquid in the world, in general, Japan significantly trails other major financial markets in the range of actively traded asset classes and the infrastructure needed to support them. Similarly, in fintech—the leading edge of payments and banking infrastructure—Japan has fallen behind in critical areas. Addressing these gaps is necessary for encouraging innovation, new entrants, and expansion of existing players.

(I) INCENTIVES FOR ATTRACTING AND RETAINING TALENT AND NEW ENTRANTS

As the GOJ itself has clearly recognized, drawing in a steady flow of talent and new businesses from abroad must be a key element of any successful financial center initiative. Also important is retaining that talent by creating the conditions for a dynamic financial ecosystem that provides profit-making opportunities for value-creating firms.

Recent initiatives by the GOJ are encouraging and are to be commended. These include proposals for selected tax incentives related to inheritance taxation and carried interest and the JFSA's recent launch of a "single point of contact" service for administrative and licensing support for asset managers seeking entry into the Japanese market.

However, more can be done. There are a number of additional relatively straightforward steps the GOJ can take that would have practical benefits for incoming finance professionals and new entrants while also sending a clear message that the GOJ is serious about making significant changes to smooth the way for talent to enter and work in Japan.

Recommendations

- Expand the "single point of contact" program. The current program ("Financial Market Entry Office") offers registration and other key support resources for new entrants only in the asset management and advisory businesses. While asset management is and should be a key focus of the financial center project, the JFSA should expand the range of new entrants eligible for support to include fintech firms, and any other businesses within the financial services space, as these functions are also key components of any dynamic financial industry.
- Ensure that non-Japanese visa holders can enter and return to Japan on the same basis as Japanese nationals, with public health restrictions applied without reference to nationality.
- Revise immigration laws to allow more hiring of foreign domestic workers (FDWs). These revisions should, among other things, allow Japanese citizens and highly skilled professionals to hire FDWs directly, permit FDWs to work for multiple families and grant single individuals and those without children the ability to sponsor FDWs. Hong Kong and Singapore both provide models on which Japan could base a sensible program.
- Allow inheritance and gift tax-free transfer of overseas assets. The ACCJ appreciates the recent proposed reform that would allow for inheritance and gift tax-free transfers of overseas assets to nonresidents from long-term residents in Japan. However, we believe they are insufficient to address remaining concerns from foreigners, especially those coming from countries that do not have inheritance/estate or gift-tax regimes. In addition, Japan's inheritance and gift regimes are not in line with the laws of many other counties as evidenced by the low inheritance tax basic deduction of ¥30 million, the limited tax-free transfer of assets between spouses, and the high top tax rate of 55%. The ACCJ recommends the inheritance and gift tax-free transfer of overseas assets between foreigners, either nonresident or in Japan on Table-1 visa status, regardless of the amount of time they have resided in Japan.
- Introduction of special individual temporary tax status. A special tax status could be used to incentivize the establishment of new businesses, attract talent, and increase foreign direct investment into Japan. In particular, qualifying individuals—including new entrants, legal residents and Japanese citizens—would be taxed at the non-resident rate of 20.42% on Japan source employment income, with non-Japan source income not taxed, for some limited number of years. Minimum criteria could be applied for the business being established; for example, the number of employees hired and the type of business.
- Relax the Exit tax imposed on foreign nationals. The ACCJ appreciates the fact that the Exit tax, which is an income tax imposed on the unrealized gains in worldwide financial assets primarily when a Japan tax resident breaks residency (i.e., is no longer a Japan tax resident), will not impact foreign nationals

who are temporarily in Japan on short-term visas ("Table 1" visas). However, if one of the goals of the GOJ is to retain some foreign national talent in Japan for the longer term (requiring a more permanent type of visa or a "Table 2" visa), the Exit tax is a significant factor that could deter foreign nationals from continuing to work in Japan. This obstacle can be addressed by eliminating the Exit tax for all foreign nationals regardless of their visa type, or at the very least, ensure that any unrealized gains derived prior to becoming a Japan tax resident that are subject to the Exit tax are not included in the taxable base once the Exit tax is imposed.

(II) STRUCTURAL REFORMS FOR SUSTAINED SUCCESS AS A FINANCIAL CENTER

Corporate Governance and Transparency. Japan's financial regulators should be commended for making progress on corporate governance and stewardship in recent years.

Nevertheless, there remain many areas for improvement if Japan is to be competitive with leading markets such as New York or London. Global-leading standards in corporate governance are essential for investors to effectively engage with corporate managements in a way that will unlock the untapped value throughout Japan's corporate sector. The linkage to creating a more vibrant financial center is clear: Institutional commitment to high standards of stewardship and corporate governance leads to efficient capital allocation strategies, driving higher investment returns and increased financing and corporate activity such as non-core asset dispositions, M&A and share buybacks.

Recommendations

- While the establishment of the Corporate Governance Code has been a major step forward, full progress requires a stronger regime for adoption. A program is needed for systematic direct engagement with corporate managements to more effectively drive action on implementing global best practices of corporate governance and increasing executives' knowledge in related key areas, such as finance and modern HR management. Such a program could include accountability and training, including disclosure of timelines for implementation of key standards and policy action plans.
- The GOJ should promote understanding, and actively seek implementation, of key corporate performance metrics including return on invested capital (ROIC) and total shareholder return (TSR). This should also include globally accepted ESG disclosure standards such as those of the Sustainability Accounting Standards Board (SASB).
- Increase board diversity and independence by establishing a requirement that audit committees and committees focusing on nominations and compensation be headed by an independent outside director. In addition, implement a requirement that boards comprise a majority of independent outside directors and that companies disclose a plan for appointing at least three women to the board.
- To align the interests of boards and shareholders, the GOJ should promote greater ownership of company stock by directors and employees through the use of tax incentives. Excessively rigid trading restrictions should be eased, and directors' ownership amounts and trading activity should be disclosed.
- The Companies Act should be amended to provide that senior "executive officers" (*shikko yakuin* in addition to *shikkoyaku*) are held to the same level of legal responsibility as corporate directors.
- *Yuho* financial reports, business reports under the Companies Act, and corporate governance reports submitted to the TSE should be combined into a single report that is submitted to the FSA at least one month before the AGM of all listed companies and should be subject to sanctions for misrepresentations under Japanese securities laws. This single report should require a standardized XBRL taxonomy and other features that make it fully machine-readable and easy to render as Big Data, with the explicit goal of making Japan a leader in the area of fintech-compatible disclosure formats worldwide.
- Similarly, listed signatories to the Stewardship Code should be required to submit on a timely basis their per-agenda-item voting records for disclosure on EDINET, using a standardized XBRL format and

other features that make them easily machine-readable. The format of voting results reports submitted to EDINET by companies should also be modernized into standardized, machine-readable form.

Professionalization and Specialization. Much attention has already been given to the need to attract specialized talent into Japan from outside as a means to improve Japan's standing as a financial center. The underlying goal is to develop a deeper pool of domestic specialization and expertise within Japan's financial industry. Japan's largely bank-centric industry model contributes indirectly to a number of features in the finance industry employment configuration that emphasize general and non-specialized knowledge and skills at a time when success in the global financial markets increasingly demands specialization and sophistication, which can be achieved only through multi-year experience and training.

Recommendations

- The regular job rotations and seniority-based promotion systems typical among traditional institutional investors in Japan, including pension funds, bank-affiliated asset managers and insurance companies, limit development of long-term expertise and promote risk-aversion, with negative consequences for risk-adjusted returns, capacity for innovation and ability to establish and achieve multi-year goals. Recent public comments by JFSA Commissioner Ryozo Himino well-articulated the general need for greater specialization. Efforts should be made to devise more effective approaches toward hiring, rotations, and promotions that are better suited to developing specialists capable of meeting the current and emerging requirements of modern finance.
- In the individual advisory sector, systems of regular rotations of salespeople similarly reduce the service capability and accountability that is essential for any value-added client relationship, diminishing the confidence and trust of investors. These practices should be phased out in favor of a US/European-style model focused on long-term advisory relationships backed by demonstrated expertise and significantly more consequential fiduciary and suitability standards.
- Regulators and self-regulatory organizations (SROs) should re-examine advisor training, licensing, and certification regimes, and promote education and training related to finance and corporate governance. As the industry transitions to a long term-oriented advisory model and an equity market with improving governance, the educational and certification framework needs to support this change to ensure competent service and greater professionalism. Criteria for qualifying advisors must emphasize the appropriate skills and training, for example to provide a lifecycle-based approach that captures individual clients' full financial profile and client needs over various life stages. The requisite qualifications should include, at a minimum, strong working knowledge of the characteristics of various asset classes, existing investment strategies, asset allocation frameworks, and market risk. Listed companies could receive special tax credits for expenditures to train managers and executives regarding finance, governance, and directorship skills.
- The gap in the general level of professionalism and sophistication in corporate pension asset management in Japan versus other major financial markets is especially large. In addition to many of the factors cited above, this gap also reflects a number of shortcomings in the governance standards and regulatory framework applied to pensions themselves. Addressing these shortcomings would drive an enhanced level of management expertise that would improve returns and contribute directly to development of a larger class of finance professionals in Japan. To this end, the GOJ should consider creating a version of ERISA for Japan that raises standards for pension funds and requires them to sign the Stewardship Code. In addition, in order to ensure appropriate investment skills, investment professionals should meet a licensing requirement to confirm the requisite level of investment knowledge, and facilitate a system that allows only those who have extensive investment experience to be selected as pension fund managers.

Increase Broad-Based Investment Market Participation. For Japan to realize its potential as a global financial center, it is vital to increase domestic investor confidence and to increase exposure to higher-returning investment assets. Doing so can only be accomplished in the context of a wealth and asset management industry that is properly attentive to the long-term needs of investors. This requires sound advice, greater transparency, and appropriately diversified asset portfolios able to provide adequate risk-adjusted returns over the long term. More efficient deployment of individual assets is desirable not only from the perspective of the nation's long-term fiscal health; ultimately, individual savings and investment are the drivers of activity and growth in financial and capital markets.

Recommendations

- Tax-advantaged investing plans should be expanded. Despite laudable progress in developing a more accessible defined-contribution pension infrastructure in recent years via the Nippon Individual Savings Accounts (NISA) and Individual-Type Defined Contribution Pension Plan (iDeCo) programs, Japan's system remains undersized and underutilized relative to the long-term needs of investors. Contribution and tax-deductibility amounts should be expanded from current levels and greater efforts made to educate investors on the advantages of the program. Product offerings should be simplified, with an emphasis on expanding low-cost offerings and easy-to-understand information related to appropriate benchmarks and risk/reward characteristics. The life and applicability of these asset-building vehicles should also be extended to encourage long-term savings and investments by Japanese households.
- The quality and effectiveness of client advisory and financial planning must be improved by incentivizing and enforcing the industry's transition from churn-based sales approaches to advisory models that focus on long-term investing and building investment balances on which advisors earn fees. While regulators are to be commended for making notable progress on this to date, more needs to be done and faster. We suggest consideration of incentives related to fee structures that would encourage distributors to reduce fund sales fees in favor of balance-building over the long term. The industry also needs to be better educated on why this transition will result in stronger and more sustainable profitability over the long term and why it is worth the near-term costs associated with the transition.
- Investor confidence in their financial advisors' advice is key to encouraging greater participation in the financial markets. We recommend mandating disclosure measures that clarify whether the financial advisor is recommending the best investment vehicle for the investor rather than one where the advisor has an economic incentive to recommend an affiliated company investment vehicle over a non-affiliated investment vehicle. Financial distributors should also be incentivized to develop a true "open architecture" so that investors can access the best products through multiple distribution channels, therefore mitigating financial advisors' inherent conflict of interest in offering affiliated company products.
- In connection with the above, suitability standards in the individual investor market should be raised. While Japan has made progress around suitability in recent years, current guidelines lack sufficient teeth to be fully effective for instilling trust and confidence among investors that their interests are properly prioritized. Monitoring and accountability requirements regarding product placement should be strengthened, including greater investor recourse against suitability breaches.

Regulatory Infrastructure and Processes. Despite significant improvements in Japan's regulatory regime in recent years, there remains room for further progress in several areas, especially when comparing Japan to other developed markets. Inevitably, this gap hurts Japan's international competitiveness as well as the position of the Japanese financial services industry. We believe there are several regulatory reforms that are ripe for action and would increase productivity, enhance the ease of conducting business, facilitate innovation, and reduce costs, thereby improving the global competitive position of Japan and enabling the industry to play a bigger role in supporting changes in society, future economic growth and competing internationally.

Recommendations

- Japan's firewall regulations restricting sharing of customer information across operating entities within the same financial group have become outdated and act as a hindrance to innovation, customer service, FATF compliance, and the healthy expansion of financial services. This reduces the attractiveness of entering the financial services business in Japan compared to other jurisdictions while also hindering investment and innovation among established firms. Japan's rules should be updated along the lines of other major jurisdictions with more sophisticated rules that enable firms to better serve their customers while simultaneously protecting personal data.

- Although notable improvements have been made, the licensing process for financial services firms to enter the domestic market or add new businesses remains cumbersome. Limited availability of English-language support, in particular, remains a primary issue. We specifically recommend expanding the pre-registration entry scheme recently proposed by the JFSA to include all manner of financial industry entrants, not only asset managers and advisors.
- Regulatory reporting in Japan is complex and time consuming, with duplication across different agencies and self-regulatory organizations (SROs). Data requests are frequent and data definitions are often vague or unavailable. While we applaud the JFSA for its recent work to address some of these issues, moving more quickly towards a central taxonomy of data definitions would be a good first step towards digitization.
- Developing a "one-stop shop" regulatory reporting utility is essential for Japan's competitiveness as a financial center. Importantly, this need not entail consolidation of regulatory oversight into a single entity. Rather, it simply involves creation of a unified digital data repository accessible by all regulators and relevant SROs (with appropriate permissioning protocols) such that the need for duplicate data provisioning by financial services firms to multiple regulators and SROs would be eliminated.
- Permit introduction of a new type of "regular employee" contract for new financial businesses, including fintech, that would allow labor contracts of indeterminate length, as long as the employee is compensated for dismissal. This would give new businesses more flexibility in hiring strategies, enabling increased hiring more quickly without risk of being unable to downsize should future conditions necessitate it. Employees would be protected by a pre-agreed, legally enforceable severance payment based on total years of service. Termination of this category of employment contract would not be deemed void under Article 16 of the Labor Contract Law as long as the agreed severance payment is made.
- To encourage greater global regulatory coherence, the GOJ should establish an official forum, including major domestic and foreign firms, to deliberate global financial regulatory issues and priorities. Such a body would enable rulemaking balanced appropriately between global harmonization and local needs as well as provide global insight and expertise to identify potential overlaps or inconsistencies at the rule proposal stage, thus reducing global market fragmentation. In recent years, several foreign regulators, including the CFTC, have established such mechanisms, with positive outcomes. A key example in this regard is the IPO market, where in recent years Japan has been bypassed on major global transactions in favor of competing markets, largely on the basis of its lack of globally harmonized rules.

Deepen the Institutional Markets and Fintech Ecosystems: Although the scale and diversity of Japan's economy supports an existing large and liquid institutional capital market, the range of products actively traded is relatively narrow and generally less sophisticated than those of other major financial centers. In addition, although there has been much focus recently on the entrance of major international venture capital (VC) and private equity (PE) players into Japan, in fact the scale of VC and PE activity in Japan and Japan allocations in global portfolios remain small relative to the size of the economy. Policy action is needed in particular to put the VC market on a stronger, sustained growth path underpinned by greater access to serial capital raisings. These steps would contribute to increased IPO activity, more investment in Japan and stronger investment portfolio returns.

In fintech, Japan has yet to develop a strong ecosystem that embodies leadership in digital financial infrastructure and the global talent needed to support it locally, both of which are increasingly essential for its aspirations as global financial center. Though it has stepped up efforts around fintech, Japan trails in terms of number of firms incubated, investments made, and global talent attracted while also lagging in terms of digital payment use and central bank digital currency initiatives

Recommendations

- In institutional markets, we suggest a coordinated plan led by the JFSA and major foreign and domestic financial institutions that would start with a formal analysis of products and asset classes that are un-derdeveloped in Japan or where it has competitive advantages, followed by creation of an execution plan for creating the infrastructure and regulatory framework needed to accommodate them. Such a plan should particularly include increasing the range of cross-border derivative products traded on the Japanese markets, including adoption of relevant international accounting standards, as well how to expand the role of PE within the broader capital markets ecosystem.

- In market infrastructure specifically, relative to global peers Japan has seen little development of alternative trading systems. We recommend a review of the regulations that limit the volumes allowed to trade via proprietary trading systems (PTS) before triggering the requirement to register a PTS as an exchange. The current relatively low thresholds in Japan may make the establishment and operation of a PTS uneconomic for potential market participants.
- The recent outage at the Tokyo Stock Exchange has also highlighted the risks inherent to a one-venue market. More should be done to encourage the development of alternative exchanges that also have access to timely disclosure and other data that at present is monopolized by the JPX/TSE. To better compete with its global competitors, the GOJ should consider permitting execution-only exchanges and allow for securities listed on one exchange to be traded on another exchange without the need to repeat the listing examination.
- The accounting regime for domestic venture capital (VC) should be updated to international standards based on fair-value accounting. The current regime, based largely on book value accounting through the life of the investments until sale, is detrimental for an economy that would benefit enormously from a more vibrant VC ecosystem. The current accounting regime contributes to a stunted domestic VC market by inhibiting the follow-on capital raising activity that is vital for attracting new funding rounds at progressively higher valuations.
- The GOJ should establish a systematic program of engagement across the corporate spectrum to encourage restructurings, non-core asset sales and other forms of long-term value creation where PE investment plays a key role. Recent examples suggest that the government can play a constructive role in situations where domestic companies are open to discussion with PE investors but may require support and/or guidance.
- Banks should be encouraged to increase the sophistication of their credit risk analysis capabilities. Rather than basing credit extension decisions on available collateral, credit decision factors should include an assessment of business plan viability based on statistical analysis and robust modeling. This will not only improve small and medium business enterprises, including fintech's access to capital, it will enable banks to better use their available capital.
- In fintech, the GOJ should start by streamlining the number of payments services, creating a unified point-of-sale terminal standard and mandating open banking APIs. To help incubate more successful firms, creation of an "API marketplace" would stimulate growth of the overall ecosystem. Lastly, greater international collaboration is essential for accelerating development. Specifically, the GOJ should more actively seek to establish ties with other hubs, (e.g., Singapore), increasing opportunities for Japanese fintech firms to grow globally, while encouraging global firms to bring needed talent to Japan.

CONCLUSION

The Japanese government has rightly recognized both the need for and benefits of re-establishing Japan as a leading-edge global financial center. Importantly, Japan possesses the necessary attributes to achieve this goal: a highly educated and motivated population, a diverse and large economy and corporate base to support it, high levels of technological development and adoption, and a stable political environment underpinned by commitment to the rule of law. What has been missing to date is a coordinated commitment across the government and corporate sectors to address legacy structural shortcomings that are impeding the development of a financial center that leads rather than follows and that, on its current trajectory, will likely fall further behind nimbler centers. Many of the issues needing attention are challenging to address. Nevertheless, developing a more robust financial ecosystem in Japan demands that policymakers take up this challenge with a sense of urgency and determination. Doing so will not only establish Japanese leadership in global finance but also make a vital contribution to Japan's long-term economic growth.