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FOREWORD

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The investment management industry is experiencing a period of profound transformation, driven by technological advancements, regulatory shifts, and evolving market dynamics.

A central theme in this issue is the integration of artificial intelligence within the investment sector. Firms are increasingly adopting small language models to enhance operational efficiency and client engagement. These technologies are not merely augmenting existing processes but are fundamentally altering the way investment firms operate, necessitating a strategic approach to their adoption and integration.

Simultaneously, regulatory landscapes are undergoing significant shifts. The UK is transitioning from the PRIIPs regime to the Consumer Composite Investment (CCI) framework, emphasizing transparency and consumer-

centric communication. This move presents both challenges and opportunities for asset managers to enhance investor trust and operational efficiency.

On the global stage, Japan's ambition to become a world-class asset management center is gaining momentum. Through strategic reforms and policy initiatives, Japan is actively working to redirect household financial assets from savings to investments, fostering a "virtuous cycle" that aims to bolster corporate value and stimulate economic growth. These efforts are attracting both domestic and international asset managers, positioning Japan as a key player in the global investment arena.

However, these advancements are not without their challenges. The increasing reliance on generative AI introduces complexities related to data integrity and model quality. Organizations must navigate issues such as model drift and data provenance to ensure the reliability and trustworthiness of AI-driven solutions.

The evolving landscape of climate risk also is prompting a reevaluation of investment strategies. While the focus on climate transition risk remains important, there is a growing need to address physical climate risks through investments in resilience and adaptation. This shift calls for a nuanced approach to responsible investing that balances mitigation efforts with the realities of climate change.

In this edition, we explore these themes and more, providing a comprehensive overview of the forces shaping the future of investment management. We hope that the insights shared herein will serve as valuable resources for professionals navigating this complex and dynamic landscape.

EDITORIAL

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Japan is undergoing a significant transformation in its approach to household financial assets, aiming to shift from traditional savings to more dynamic investment strategies. By removing barriers to entry, modernizing regulations, and encouraging international participation, Japan aspires to become a leading asset management center. This movement is part of a broader trend where governments worldwide seek to drive economic growth through effective use of investments.

Statistics from March 2025 show that 51% of the 2,195 trillion yen (USD 14.6 trillion) in Japanese household financial assets remains in cash and deposits, which is roughly 1.6 times the proportion seen in Europe and about 4.4 times that in the United States. In Japan, only 19.6% of household financial assets are allocated to securities. In recent years, with measures to promote investment such as Nippon Individual Savings Account (NISA) and individual-type Defined Contribution pension plan (iDeCo), the share of investments has grown by 3.6 percentage points over the three years since 2022 from 16.0% to 19.6% with the share of investment trusts rising from 4.5% to 6.0%. Japan thus represents a market with enormous potential for asset managers.

The first article explores the Japanese government's strategy to redirect household savings into investment, fostering a virtuous cycle of growth and distribution. Key reforms, such as the 2024 amendment to the Financial Instruments and Exchange Act, are designed to introduce greater flexibility and expertise, making Japan more attractive to both domestic and international asset managers.

The second article highlights the Japan Financial Services Agency's (JFSA) "Policy Plan for Promoting Japan as a Leading Asset Management Center." The plan is a long-term initiative with tangible results already visible, such as rising assets under management. The JFSA seeks to further invigorate the domestic market by welcoming global asset management firms and enhancing competition.

The third article focuses on tax and legal reforms that facilitate foreign investment. Tax exemptions for permanent establishments and updated rules on limited partnerships and unlisted stocks are making Japan's market more accessible to overseas investors. These measures are expected to channel more capital into startups and offer diversified opportunities, further strengthening Japan's investment landscape.

In this edition of Performance, various approaches for Japan becoming a leading asset management center are discussed. The Japanese market is expected to bolster its status as Asia's asset management hub, drawing investment capital and technology globally.

Shaping tomorrow through investment: Japan’s vision as a leading asset management center

UNITING GOVERNMENT INITIATIVES TO FOSTER A “VIRTUOUS CYCLE OF GROWTH AND DISTRIBUTION,” POWERING JAPAN’S LONG-TERM ECONOMIC GROWTH

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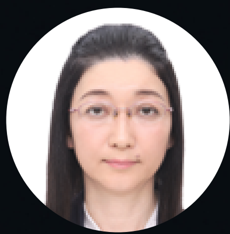

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INTRODUCTION

Japan’s government believes in fostering growth and distribution by transferring household savings which make up over half of financial assets to investments. The objective is to boost corporate value and return benefits to households. The government has been taking initiatives for households, financial products sales companies, corporations, financial and capital markets.

Following these initiatives, the government will focus on household financial assets as the remaining piece of the investment chain. Aiming to reform asset management and ownership, Japan’s national strategy focuses on becoming a leading asset management center. The government is making reforms to attract both domestic and international asset managers to the Japanese market.

Despite barriers such as complex entry procedures, unique business practices, and limited sales channels, Japan’s government launched the Policy Plan for Promoting Japan as a Leading Asset Management Center in December 2023, aiming to upgrade the asset management sector and attract overseas entrants.

1. Revision of the Financial Instruments and Exchange Act: Institutional reform to change the structure of the investment business

The revision of the Financial Instruments and Exchange Act in 2024 was an important step in reexamining the structure of Japan's asset management business. Lifting the ban to give investment managers full authority to issue investment instructions, and creating a voluntary registration system for middle and back office operation businesses are crucial reforms. These changes are part of the Policy Plan for Promoting Japan as a Leading Asset Management Center, designed to introduce a new flexibility and expertise to the Japanese investment business.

i. Lifting the ban on full investment instruction authority: opening opportunities for small and medium-sized players.

Under the previous system in Japan, investment managers were prohibited from outsourcing all investment decisions. Managers were required to make investment decisions at least partly on their own, and there were limitations to outsourcing all trading activities.

However, the 2024 regulatory revision lifted the ban on the full delegation of management authority, making it possible to outsource actual investment decisions and execution to external specialized players while investment managers focus on designing management policies and portfolio strategies.

This will allow a division of roles between companies handling investment execution and those designing investment strategies in Japan, similar to business models in Europe, the US, and Japan's "outsourced model." Small and boutique managers can now focus on innovative asset management.

ii. Voluntary registration system for middle and back-office operations: Securing reliable contractors

Another noteworthy development is the establishment of a voluntary registration system for middle and back-office operations in investment management. Obtaining a Japanese investment management license is challenging for new, small, and overseas companies due to the need for significant equity capital, experience, and a strict internal control system. Additionally, there was no cross-industry framework for vendors and custodians undertaking middle and back-office operations in Japan's asset management industry. Therefore, the quality of services and management systems varied from business to business. Even established investment managers have struggled with outsourcing middle and back-office operations.

The new system allows the Financial Services Agency to certify business operators with proper control, information management, and compliance systems. This infrastructure enables investment managers to entrust their businesses with confidence, ensuring reliable outsourcing while enhancing operational efficiency and quality.

Please refer to the appendix below.

Appendix

The 2024 revision of the Financial Instruments and Exchange Act allowed investment managers to outsource middle and back-office operations (compliance and accounting) to qualified firms. A new registration system has been introduced for those handling these operations, who are referred to as "Contractors" once registered.

If an investment manager outsources compliance or accounting tasks to Contractor, it does not need in-house employees with detailed expertise in those areas, only those capable of properly supervising the outsourced work performed by Contractor.

In recent years, when registering investment management businesses, it is particularly difficult to secure compliance officers, which is said to be a barrier to new entrants. In other words, there is a requirement for "a compliance division (or designated person in charge) to be established independently from the asset investment division, and for personnel with adequate knowledge and experience to be appointed at this role." However, due to the lack of special qualifications and education systems for compliance officers, human resource development has been slow, and the number of compliance officers has not kept pace in line with the growing number of investment managers who wish to register.

For international investment managers, communication with overseas compliance supervisors is essential, and requires English proficiency, increasing the challenge of recruiting talent in Japan. In addition, small investment managers often rely on a single compliance officer within their companies, risking non-compliance if they retire.

Under the revised law, investment managers will no longer need to hire full-time compliance officers if they outsource compliance work to Contractors. Instead, it is necessary to have "officers or employees who are capable of supervising the relevant operations." This supervisor does not need to have direct experience in compliance work. "Managing officers" required for investment management business registration must have ample compliance and risk management expertise and may also serve as supervisors.

Outsourcing compliance work to a Contractor allows investment managers to reduce costs and time spent finding compliance officers, reducing risks of mismatch and retirement, as well as social insurance costs.

Another advantage is that Contractors specialize in compliance operations, have expertise and experience, ensuring high-quality compliance aligned with market practices.

Upon registration, Contractors are assessed on their knowledgeable and experienced employees and strong internal control systems. In addition, Contractors are subject to legal restrictions such as duty of loyalty to investment managers, duty of care as a prudent manager, prohibition of re-entrustment in principle, and obligation to preserve records.

However, registration as a Contractor is voluntary and not mandatory for companies undertaking middle and back-office operations on behalf of investment managers. If outsourced to an unregistered firm, the investment managers must maintain personnel requirements, including hiring a full-time compliance officer.

Even when outsourcing these operations, investment managers remain responsible for acting in the best interest of investors. This means they must choose a reliable Contractor, sign an appropriate contract, and maintain an effective oversight system.

Since compliance officers will no longer be company-based, investment managers need to actively disclose compliance-related concerns to Contractors as part of their daily operations, consult with them regularly, and establish a system to respond to their feedback.

Contractors are also required to develop robust systems for information exchange, management, and reporting in collaboration with investment managers. Compliance issues vary by company, which requires tailored internal rules. Collaboration between investment managers and Contractors is necessary to develop an effective compliance system.

Note that the relaxation of personnel structure requirements in this legal revision apply only to Investment Management Business Operators under the Financial Instruments and Exchange Act. They do not affect registration requirements for those also registered as Type II Financial Instruments Business Operators or as real estate investment advisers with the Ministry of Land, Infrastructure, Transport and Tourism for managing real estate funds.

In other words, some businesses may still need to appoint compliance officers to meet other registration requirements other than investment management. Even in such cases, they can outsource parts of the compliance work or consult with Contractor. With the new registry of Contractors, it will be easier for financial instruments business operators to find reliable support for middle- and back-office operations, since the published list will include Contractors approved and supervised by the Financial Services Agency. It is expected that the usage of this system will increase the number of investment managers in Japan, which in turn will accelerate the shift from savings to investment.

2. Asset owners and household financial assets: Leveraging idle cash holdings

In Japan, households have around 2,000 trillion yen in financial assets, with more than half in cash and deposits. The government expects asset owners, like corporate pension and university funds, to strengthen asset management and become key investment chain players. Asset owners should manage necessary risks to boost asset performance and investee company growth, contributing to startup funding. The Japanese government is implementing major reforms targeting asset owners and household assets as part of the "Leading Asset Management Center" strategy.

i. Asset ownership reform: Formulation of asset owner principles

The Financial Services Agency has developed the Asset Owner Principles to guide asset owners— such as pension funds, insurance companies and university endowments—

in serving the best interests of their beneficiaries. These principles emphasize clarification of investment objectives and targets, the development of appropriate systems, risk management, transparent reporting of investment results, and well-defined criteria for selecting investment contractors.

In line with this initiative, a new law has been enacted in Japan to strengthen protections for beneficiaries, including insurance and pension subscribers and universities.

The government is working on a system to maximize returns for beneficiaries by improving investment management practices that support corporate growth and generate social impact, thus moving beyond a focus solely on risk aversion. As asset owners and their fiduciaries—those responsible for asset management— adopt more sophisticated practices in line with the evolving Japanese investment chain, the overall investment capabilities of the industry are expected to improve. This should promote medium to long-term growth for investee companies, enhance corporate value, and foster healthy competition among investment managers.

ii. Approach to household wealth: Promoting investment through tax incentives and financial education

In 2024, Japan introduced a new NISA system, modeled on the UK's ISA, as an investment promotion measure for individual investors. It offers a maximum tax-free investment limit of 12 million yen per person, with an indefinite tax-free period. Individual investors favor long-term, accumulated, and diversified investment, and in 2024 NISA purchases totaled 17.4 trillion yen.
Furthermore, financial literacy education for young people has been accelerated, mainly through the Japan Financial Literacy and Education Corporation (J-FLEC) established in 2024. Efforts focus on empowering individuals to manage their finances at school, work, and in their communities.

iii. Corporate governance reform and maturation of market culture

Corporate governance reforms led by the Japanese government are also a major tailwind for the maturity of the investment environment. Listed companies must consider capital costs and stock prices, while the Stewardship Code is being reinforced, leading to more meaningful engagement.

In Japan, a "market culture" where companies and investors collaborate to enhance value through dialogue has been steadily taken root. This creates an environment for overseas asset managers who are committed to long-term and responsible investment to engage seriously with Japanese companies and create value.

3. Japan's Thriving Asset Management Market with Global Connections

In Japan, the government is now taking the lead in supporting the formation of an ecosystem for investment services and funding, and the entry of foreign players. By becoming an asset management center, the local market is expected to strengthen its position as an asset management base in Asia and attract global investment capital and technology.
With significant changes in household asset allocation expected, Japan's asset management market is poised for strong growth. The Japanese government and industry leaders anticipate that global asset managers will offer advanced solutions to households, boosting Japanese companies and the economy through investment.

The 17 trillion yen NISA purchase in 2024 may seem small from the perspective of Japanese households overall. However, looking back at the introduction of 401 K in the US and Superannuation in Australia, 2024 might be seen as a significant turning point for Japan's asset management market.

With the Japanese government reaffirming the asset management business's role in the investment chain, we believe that contributing to or entering the Japanese asset management market should be regarded as an important strategic priority for global asset management players.

CONCLUSION

- The Government of Japan is reforming the asset management industry to make the local market more attractive to both domestic and international asset managers, as part of a national strategy to become an asset management center.
- The 2024 institutional reforms, including allowing investment managers full authority to issue investment instructions and creating a voluntary registration system for middle and back-office operations, aim to enhance flexibility and expertise in Japan's investment management business.
- Asset owners such as corporate pension and university funds, holding significant assets, are expected to become key players in the investment chain by strengthening their systems and improving their investment management capabilities.
  By becoming a Leading Asset Management Center, the Japanese market is expected to bolster its status as Asia's asset management hub, drawing investment capital and technology globally.

TO THE POINT

The Japanese government seeks to redirect household financial assets from savings to investments, fostering a virtuous cycle where corporate value growth benefits households and stimulates further investment and consumption.

Building on previous efforts targeting stakeholders in the investment chain, the government is now prioritizing reforms in the asset management sector to complete the initiative.

The 2024 amendment to the Financial Instruments and Exchange Act marks a key step in restructuring Japan's asset management industry, introducing greater flexibility and expertise through new policies.

Building Prosperity: Japan’s ambition to become a world-class asset management center

AN IN-DEPTH CONVERSATION WITH THE JAPAN FINANCIAL SERVICES AGENCY (JFSA) DEPUTY COMMISSIONER FOR INTERNATIONAL AFFAIRS ON THE GOVERNMENT’S PLANS TO ACHIEVE A VIRTUOUS CYCLE OF GROWTH AND DISTRIBUTION

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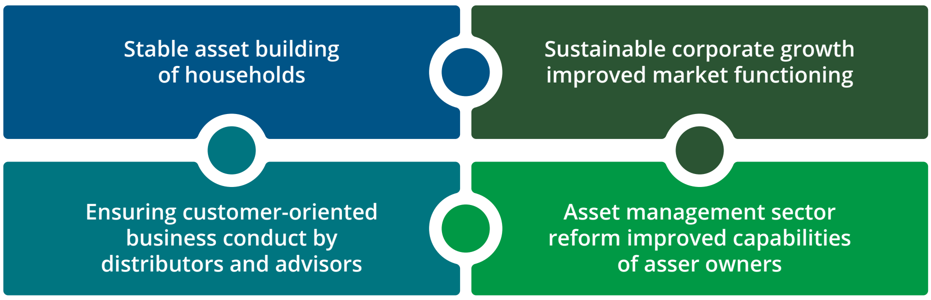
INTRODUCTION

The Financial Services Agency, Government of Japan (JFSA), has published the "Policy Plan for Promoting Japan as a Leading Asset Management Center" in December 2023, with the aim to reform Japan's asset management sector and asset ownership.

Under former Prime Minister Kishida's initiative towards revitalizing the Japanese economy through policy measures known as "the new form of capitalism", the Japanese government has been taking various measures to achieve a "virtuous cycle of growth and distribution" in which Japan's household savings flow more into return-seeking investment, and the benefits of increased corporate values are returned to households, leading to further private sector investment and consumption.

Of particular point to note in relation to the asset management business, the initiative focuses on engagement by stakeholders in the investment value chain, including households, corporations, distributors, asset managers, and asset owners to encourage these dynamic.



Source: Financial Services Agency, 2025

We had the honor of interviewing Mr. Jutaro Kaneko, Deputy Commissioner for International Affairs of the JFSA, and to hear first-hand how the Japanese Government is pursuing this initiative.

Mr. Kaneko joined the Bank of Japan in 1997 and has held various leadership positions in both the Bank of Japan and the JFSA. including Director for International Financial Markets (Settlements) at the JFSA and Director and Deputy Head of International Division of Financial System and Bank Examination Department at the Bank of Japan. He has been in his current role at the JFSA since 2024.

***Performance Magazine 47 (PM47):* What is the background to this policy measure?**

Mr. Jutoaro Kaneko (JK): The aim is to realize a virtuous cycle of growth and distribution. Household funds that are allocated from savings to investments will allow companies to invest more to increase their corporate value. As a result, we expect that the benefits will be reflected in household incomes, particularly through increased asset income.
Japan has one of the largest household asset amounts in the world, totaling approximately 2,200 trillion yen. However, a majority of these assets are held in the form of cash and deposits.

During the era of low inflation and deflation, the opportunity cost of holding such large amounts in cash may not have seemed significant. However, this situation is not ideal for long-term economic growth. Additionally, Japan is facing demographic challenges such as an aging population and a declining birth rate. This means that Japanese citizens need to prepare for longer lifespans after retirement. In light of these factors, we decided to take policy actions to ensure the lifelong financial well-being of Japanese citizens.

PM47: How do you see the investment chain/asset management business chain in Japan?

JK: To realize a virtuous cycle of growth and distribution, major stakeholders—including households, distributors, asset managers, asset owners, and companies—must function effectively and collaboratively. To this end, the Japanese government has already implemented various measures, such as introducing Japan's Corporate Governance Code and Japan's Stewardship Code to reform corporate governance. We have also developed the "Principles for Customer-Oriented Business Conduct."

While significant improvements have been observed in several segments of the investment chain, we believe the asset management sector remains a critical missing piece.

Therefore, in December 2023, we launched a flagship policy aimed at stimulating the Japanese asset management sector, which we believe has enormous potential but is not yet functioning as it should.

PM47: In each of the investment value chain, which area are the particular focus/responsibility of the JFSA?

JK: Promoting Japan as a leading asset management center involves engagement by

the entire Japanese government. The JFSA is involved in every related policy measure to varying degrees.

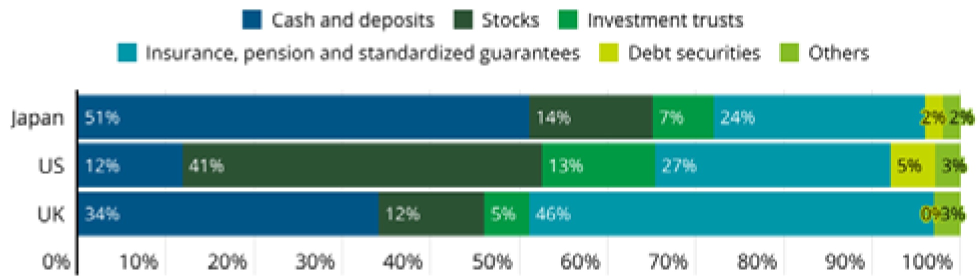
For example, individual pension plans like iDeCo (Individual-type Defined Contribution Pension Plan) fall under the authority of the Ministry of Health, Labor, and Welfare. The Ministry of Finance is responsible for favorable tax treatment, and understandably, they are cautious about providing tax incentives without reliable alternative funding sources. Despite this, the Japanese government as a whole shares a common goal of ensuring financial well-being for Japanese citizens in the long term.

We can state policies addressing financial and economic education, as well as the asset management sector, are of utmost importance.

PM47: Given the various policy measures that the JFSA has introduced, can we say that JFSA is welcoming foreign asset managers entering business in Japan? What does JFSA expect from foreign asset managers?

JK: The entry of talented asset managers into Japan's asset management industry will stimulate competition, foster a more diverse and highly specialized talent pool, and drive the industry's overall growth. To encourage foreign asset managers to enter the Japanese market, we have implemented measures such as establishing the "Special Zones for Financial and Asset Management Business" in Tokyo, Sapporo, Osaka, and Fukuoka, and launching the Financial Market Entry Office, which provides one-stop English support for the registration process to foreign asset management companies establishing a new base in Japan.

Comparison of Household Financial Asset Portfolios by Country (as of Dec. 2024)*



Key figures of the policy plan progress

		As of Oct. 2021	Latest Figure
Market	Nikkei 225 Index	¥ 28,771	¥ 36,045 *(as of Apr. 2025)*
	TSE Market capitalization (month-end price)	¥ 771 trillion ($4.88 trillion)	¥ 953 trillion ($6.03 trillion) *(as of Apr. 2025)*
Asset Management	Asset under management of asset management companies (gross)	¥ 757 trillion ($4.79 trillion)	¥ 1,040 trillion ($6.62 trillion) *(as of 4Q 2024)*
Household	Household financial assets (combined ratio of stocksand investment funds)	¥ 2,036 trillion (18%) ($12.89 trillion)	¥ 2,230 trillion (22%) ($13.79 trillion) (as of 4Q 2024)
	NISA accounts	17.65 million	26.47 million (as of 1Q 2025)
	NISA accounts purchases	¥ 26 trillion ($0.16 trillion)	¥ 59 trillion ($0.37 trillion) (as of 1Q 2025)
Corporate Governance	Number of companies that responded to the TSE's request (Prime)	-	1,493 (91%) (as of Feb. 2025)
	Ratio of cross-shareholdings	12.7%	11.2% (as of 1Q 2024)
Resolution of Social Issues	Sustainability Investment (Global Share)	¥ 2.8 trillion (8%)	$ 4.3 trillion (14%) (as of Dec. 2022)

Source: Financial Services Agency, 2025

(Note 1) Pension entitlements related to private pensions (funded method) are recorded as assets in the "Pensions, Insurance and Fixed Guarantees" of each country, but those related to public pensions (pay-as-you-go method) are not recorded.

(Note 2) Outstanding amounts of stocks, investment trusts, and debt securities in Japan include estimates proportionally based on the outstanding amount of foreign securities investment (Total of shares issued by non-residents, foreign investment trusts, and bonds issued by non-residents) in the Bank of Japan's Flow of Funds Statistics.

Source: Compiled by the Financial Services Agency based on data from Bank of Japan, Federal Reserve Board, and Office for National Statistics

PM47: How successful have these measures been so far?

JK: Fortunately, our efforts have shown tangible outcomes. Assets under management by asset management companies are increasing, and household financial assets are also on the rise. Nippon Individual Savings accounts (NISA) have significantly grown, with one in four individuals aged 18 or older now holding a NISA account. Corporate governance reforms in response to requests from the Tokyo Stock Exchange have also led to improved profitability and efficient capital use.

PM47: Please introduce what Japan is doing to improve financial literacy.

JK: The level of financial literacy among Japanese citizens is said to be not necessarily high. Not many people feel they have been adequately educated in financial matters—whether in school, at the workplace, or in their communities. As a result, they often lack confidence in taking investment risks.

While promoting the asset management industry in Japan, we are keenly aware of the necessity to provide high-quality financial education to Japanese citizens. This education is essential to protect them from potential losses, financial fraud, and emerging risks related to financial digitalization. Based on this belief, we advocate long-term, diversified, and accumulative investment as a reasonably assured approach to asset formation for ordinary retail investors.

In the past, various efforts were made independently by different entities—government agencies, the central bank, and financial associations. However, to integrate and streamline these resources, we established Japan Financial Literacy and Education Corporation (J-FLEC) in April 2024 and it began full operation in August of the same year. J-FLEC provides financial education to workplaces, schools, regional communities, and town halls from a neutral standpoint, free from influence by any particular party. They conduct free-of-charge seminars and events and dispatch lecturers to various locations. What I find unique about J-FLEC, compared to its counterparts in the US and UK, is its certification system for financial advisors to ensure the neutrality and quality of the education provided through J-FLEC.

PM47: In which areas have J-FLEC been successful, and in which areas do you think it needs further work?

JK: It may be a little premature to assess the effectiveness of J-FLEC's activities. However, given that Japanese retail investors didn't engage in panic selling during recent stock market turmoil, it may not be too much to say that our advocacy for long-term, diversified, and accumulative investment is beginning to resonate with Japanese households, especially among the youth. On the other hand, we are aware that more work is needed, particularly in securing enough lecturers and advisors, especially in rural areas of Japan.

PM47: How is the "Special Zones for Financial and Asset Management Business" developing?

JK: Access to the Japanese financial market is improving. For example, Local governments offer startup support programs, for foreign firms in setting up their business and living in Japan, and in some cases they provide subsidies to partly cover initial set-up costs.

The government also offers programs to support financial instrument business license applications, compliance officer recruitment, visa applications, and even helping find schools and hospitals for accompanying family members.

This program is offered in parallel with the Financial Market Entry Office (FMEO), which provides one-stop English support for registration process to foreign asset management companies establishing a new base in Japan. While Tokyo, as a major metropolitan area, will attract many foreign asset managers, I hope the government's initiative will also contribute to the development of other regions, including Sapporo, Osaka and Fukuoka.

PM47: The changes to the Financial Instruments and Exchange Act allowing outsourcing of middle-back-office functions for investment managers are now in effect. What is your expectation from these regulatory changes?

JK: The purpose of this reform is to allow asset managers to focus on their core asset management operations by outsourcing middle- or back-office functions. Through this, we anticipate that the capability and diversification of asset managers in Japan will be enhanced by promoting new entrants.

In addition to these regulatory changes, from the perspective of foreign entrants, we are encouraging the industry to abolish Japan-specific business customs, such as the daily calculation of investment fund values that were previously double-checked by both asset managers and trust banks. By removing such outdated practices, which may have served as barriers for foreign entrants, we hope to see an increase in the number of asset managers in the Japanese market.

PM47: What do you think are the next steps in growing the asset management business in Japan?

JK: Our goal is to ensure the lifelong financial happiness of Japanese citizens through financial services. We believe all possible measures have been taken but, considering that the effectiveness of these measures is limited, fundamentally, we need to address broader issues to enhance the attractiveness of the Japanese capital market. This includes convincing foreign investors and financial institutions that the Japanese economy will grow sustainably.

Challenges such as aging, climate change, and the effective use of technology must be tackled. From my personal view, I am particularly interested in how we can harmonize our policy for promoting Japan as a leading asset management center with our fintech initiatives, including the use of artificial intelligence.

Last month, the JFSA published the first discussion paper on artificial intelligence, based on a survey from various stakeholders. The survey revealed that Japanese people are relatively conservative about using AI in financial services. Given that we are opening up the asset management market, I hope foreign asset managers entering Japan will pay close attention to emerging risks associated with AI, such as misinformation generated by AI systems especially in cases where service providers directly reach retail investors with products like AI-based investment advice.
While "human-in-the-loop" approaches are often recommended to mitigate these risks, implementing them can be costly, requiring expertise in areas like law, accounting, and finance.

My wish is for foreign asset managers to ensure a good level of human oversight to protect Japanese retail investors, who are beginning to find the courage to invest their financial assets.

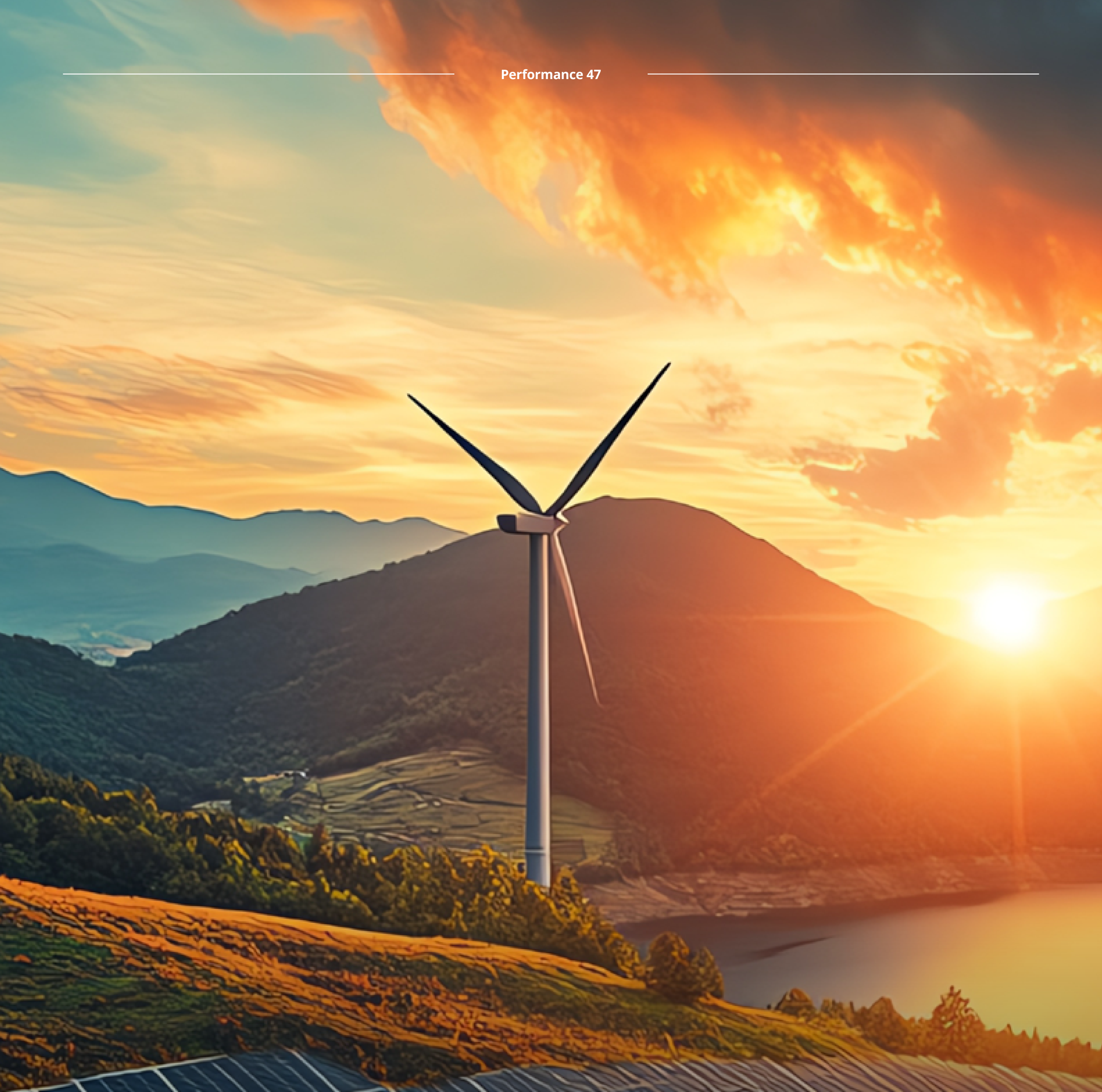
https://www.fsa.go.jp/en/news/2025/20250304/aidp.html

CONCLUSION

- The Government of Japan has been reaching out to various entities in the investment chain to encourage achieving a "virtuous cycle of growth and distribution" through an increased flow of Japan's household savings flow into productive investment.
- Measures taken include:
  1. Doubling Asset-based Income Plan,
  2. Corporate governance reforms, and
  3. Reform of Asset Management Sector and Asset Ownership
- The Reform of Asset management Sector and Asset Ownership which includes a new program to assist international entrants is the remaining piece for the growth of Japan's economy and Japanese people's asset income.

TO THE POINT

- The JFSA considers the "Policy Plan for Promoting Japan as a Leading Asset Management Center" as a long-term, sustainable policy as the ultimate goal is the lifelong financial well-being and happiness of Japanese citizens.
- Efforts have shown tangible outcomes. Assets under management by asset management companies are increasing, and household financial assets are also on the rise in Japan.
- However, there remains considerable growth potential, and the JFSA aspires for the entry of international asset management players to enhance healthy competition and bring renewed dynamism to Japan domestic asset management industry.



Rethinking net zero: Is it time to focus on resilience and adaptation?

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Green energy must be competitive to succeed

The green transition has faced challenges recently due to changes in policies, both in the United States and across Europe. Implementation of costly emission abatement is politically difficult. Europe's commitment to climate transition is being challenged by energy security risks, reflected in high electricity prices, hurting industrial competitiveness. Canadian Prime Minister Mark Carney, despite his prior engagements for climate initiatives, has eliminated the Consumer Carbon Tax. The European Union Member States agreed in May 2025 to exempt approximately 90% of importers from the upcoming Carbon Border Adjustment Mechanism (CBAM).

The Paris Climate Agreement (PCA) has the overarching goal to hold the increase in the global average temperature to less than 2°C above pre-industrial levels and pursue efforts "to limit the temperature increase to 1.5°C above pre-industrial levels" by reaching net-zero greenhouse gas emissions around 2050. The PCA operates on a system of voluntary commitments, and there are no legally binding enforcement mechanisms to ensure countries meet their national commitments. Most countries have voluntary commitments that are above the PCA's 1.5°C target. This lack of enforceability means that even the few countries with ambitious targets are not legally compelled to achieve them and there are no penalties for non-compliance. While over 100 countries have announced net-zero targets in line with the Paris Agreement, only six countries (not all EU member states currently have legally binding net-zero targets for 2050) have enshrined these commitments into law currently–less than 3% of global emissions.

For the green transition to succeed, green energy must become cost-competitive with fossil fuels. This could be achieved through innovation, regulation, and the proper pricing of carbon emissions. Regulation could lower the relative costs for green energy through carbon taxes, emissions rights, or CBAM, but not on a global scale. Innovation will require significant investments to enhance the cost efficiency of green energy and emission reduction technologies.

The commitment to the PCA is an example of a Collective Action Problem, which occurs when individually rational behavior leads to a collectively suboptimal outcome. Each individual country has little incentive to contribute to the maintenance of the global public good–limiting global temperature increase and thus mitigating climate change–even though all would reach superior outcomes if everyone contributed. The superior outcome could be reached through collectively binding agreements.

To stay within the 1.5°C warming limit, the UN Intergovernmental Panel on Climate Change (IPCC) and the UNEP Emissions Gap Report recommend that Global emissions in 2030 must fall to around 33 GtCO$_2$e. This is a required reduction from 2022 levels by ~24.4 GtCO$_2$e (~42.5%) from the estimated ~57.4 Emissions (GtCO$_2$e) in 2022.

The International Renewable Energy Agency (IRENA) and International Energy Agency (IEA) presented similar estimates of $4.5 to 5 trillion investments required per year to 2030 (starting 2023) for a successful energy transition, with transition technologies representing 80% of the total investment. IEA estimates the annual gap to target investment levels as $2.7 trillion. Climate Policy Initiative even estimated an annual investment target of $7.5 trillion per year to 2030, which is a 4-5x increase from 2023 estimated investments.

At this point, it can be concluded that the likelihood of reaching the PCA goals is very low.

Free Riders will both save on climate transition costs and reap cheap fossil fuels

Free-rider behavior is a key challenge to the collective action problem of facilitating the global public good "climate change mitigation." Since no country can be excluded from the benefits of climate change mitigation, a Free-rider country gains the benefits of the public good while maintaining high emissions.

In the following, oil is taken as a representative fossil fuel. Oil production has been steadily rising since the 1960s (see Table 1) with only one notable decline due to the pandemic. Even with stronger mitigation policies, energy systems have long lifespans (e.g., vehicles, pipelines, refineries). Transitioning from oil takes decades, so even with increasing clean energy investments, crude oil will continue to be produced and consumed steadily in the medium term.

Table 2 shows that while in the Net Zero and Transition scenarios oil output decreases, oil production is projected to increase in the scenarios that project the current regulatory backdrop. For 2050, the International Energy Agency (IEA) projects oil prices per barrel at around $25 for the NZE, $58 for the APS, and $90 for the STEPS scenario.

Table 1: Global crude oil production from 1965 to 2023, with projections (P) to 2030. Values are in million barrels per day (mb/d), based on data from the Energy Institute and IEA.

Year	**Production** (mb/d)
1965	31
1970	46
1980	59
1990	66
2000	74
2010	82
2015	91
2019	95
2020	88 (pandemic drop)
2023	94
2025P	96
2030P	97

This means that the efforts of some countries to their lower fossil fuel demand will give additional incentives for Free-Rider behavior of other countries since expected prices of fossil fuels may decrease.

The Free-Rider issue corroborates the prior conclusion on the low likelihood for the PCA's success: there will still be economic incentives to use fossil fuels, as mitigation actions will lower demand and thus lower prices for fossil fuels.

Are there still climate-related investment opportunities?

Despite low chances for the PCA's success, there can still be opportunities in climate-related investments.Due to weakening policy support, investor appetite for earlier stage, less competitive green technologies has decreased. The medium-term climate transition risks are waning due to lower regulation, resulting in decreasing emissions costs and moderating stranded assets risks.

Figure 1 shows rising supply for all energy sources, fossil fuels alongside renewables, over the last decades.The current energy system is still 80% fossil-fuel-based, predominantly coal, oil and natural gas. Wind and solar can be cost-competitive to conventional sources (see Table 3), while newer carbon reduction alternatives (e.g., green hydrogen, carbon capture) would still require significant investments to reach competitiveness.

Artificial intelligence and data centers will become a new critical energy demand driver. By 2030, global electricity demand from data centers is projected to more than double, reaching approximately 945 terawatt-hours (TWh), equivalent to Japan's current total power consumption.

Due to the rising future energy demand, growth of both conventional and renewable energy (e.g., solar, wind) seems more likely than a substitution of fossil fuels by renewables.

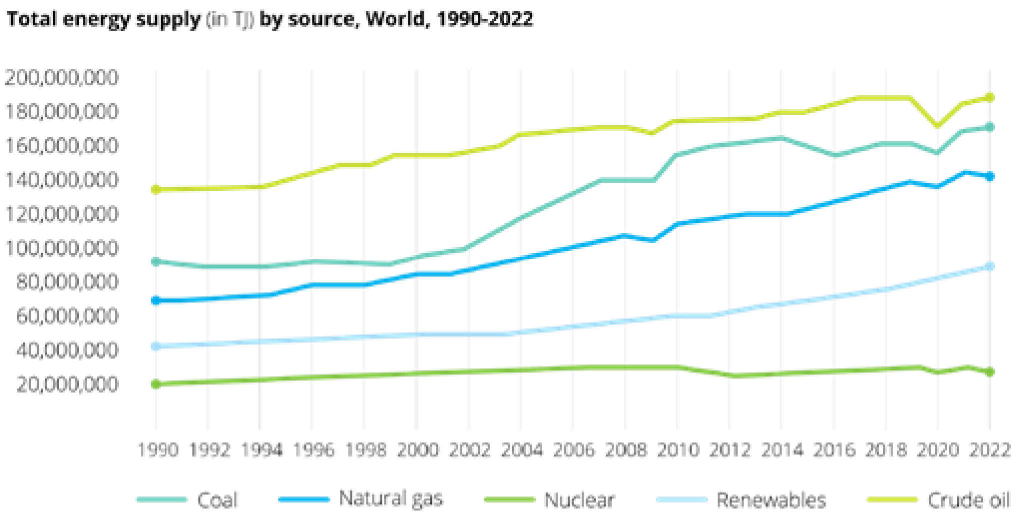
Climate resilience investment with return potential

As emissions reduction investments stall, the physical

***Table 2: Overview of crude oil production under different climate scenarios. The 2022 baseline was about 97 (mb/d).**
Green shading indicates Net-Zero Scenarios
Teal indicates Transition Scenarios, Source Internation Energy Agency and IEA.

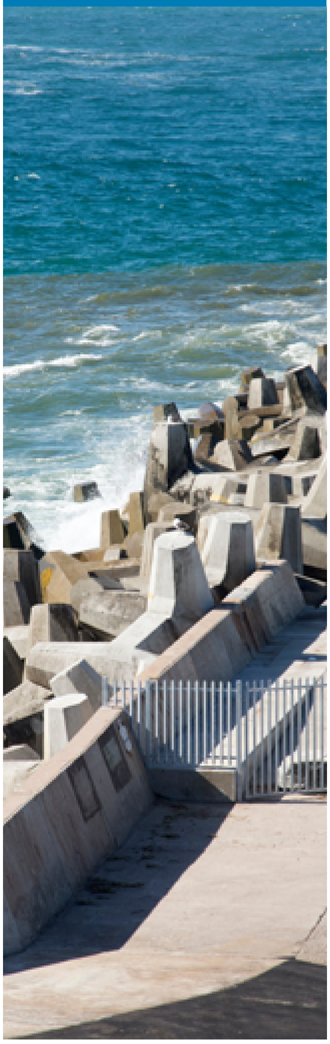
Scenario	**2030 Estimate** (mb/d)	**2050 Estimate** (mb/d)	**Key Assumptions**
IEA Net Zero Emissions (NZE)	~75	~24	Aggressive climate action, no new oil fields beyond current approvals.
IEA Announced Pledges (APS)	~88	~55	Full implementation of nationally determined contributions and net-zero pledges.
IEA Stated Policies (STEPS)	~96	~85	Continuation of current policies; moderate decline post-2030.
EIA reference case (2023)	~100	~102	No new climate policies; continued growth in demand.
BP current trajectory	~101.7	~76.8	Current policies.
BP Net Zero Scenarios (2023)	~70	~30	Rapid eletrification, fuel efficiency and green investment.
OPEC World Oil Outlook (WOO)	~104	~110	Assumes robust global oil demand growth and economic expansion.
S&P Reference	~109.3	~100.8	High demand, limited transition.

Figure 1: Total energy supply (in TJ) by source, World, 1990-2022, Source: International Energy Agency.



TO THE POINT

- The article aims to analyze the opportunities for responsible investments related to climate change mitigation. An economic policy perspective is applied concluding that the objectives of the Paris Climate Agreement may not be reached. While climate transition risk is declining, the increasing physical climate risk can create investment opportunities related to resilience and adaptation.



risks from climate change rise significantly. Physical climate risks represent the negative impacts of climate change on physical assets, ecosystems, and human populations manifesting as acute events like extreme weather or chronic changes like rising sea levels, increased temperatures, and changes in precipitation patterns. Unlike mitigation, adaptation frequently has private good characteristics. Resilience investments have immediate, localized benefits, reducing the free-rider problem. Building resilient systems is a risk-management strategy akin to buying insurance against worsening climate events. Early adaptation actions often cost far less than post-disaster recovery and may offer first-mover advantages.

Examples are prevalent in capital-intensive sectors such as infrastructure, energy, real estate, and agriculture. Investments are increasingly not only risk mitigation but strategic in nature. Real estate resilience review and certification is an example of risk mitigation investments that may contribute to property values.

CONCLUSION

As climate transition risks have abated, achieving the objectives of the PCA becomes unlikely. Physical climate risks will grow in importance. Resilience and adaptation offer essential risk mitigation and attractive long-term investment opportunities.

Table 3: Levelized Cost of Energy (LCOE) Comparison for renewable and conventional energy ($/MWh)). LCOE is a financial metric that estimates the average cost of producing electricity over the lifetime of a power plant to compare the cost of different electricity generation technologies on a consistent basis. Source: Lazard.

Type	Description	LCOE in $/MWh
Renewable	Solar PV - Utility scale	29-92
	Solar PV + Storage - Utility scale	60-210
	Wind - Onshore	27-73
	Wind + Storage - Onshore	45-133
	Wind - Offshore (unsubsidized)	74-139
	Green hydrogen (25% blending with natural gas, unsubsidized)	171-300
Conventional	Gas combined cycle (operating) (marginal cost)	23-37
	Gas combined cycle (new build)	45-108

1 The author is Chief Risk Officer at SEDCO Capital. SEDCO Capital has become the first Shariah-compliant and Saudi Arabia-based asset manager to be a signatory of the UN Principles for Responsible Investment in 2014. SEDCO Capital integrates socially responsible investment (SRI) and Shariah-compliant investment into a concept called Prudent Ethical Investment (PEI), with has additional benefits to SRI only. SEDCO Capital has been a pioneer for responsible investment in the Saudi real estate market.

Update on the Japanese investment environment

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INTRODUCTION

Tax reforms and evolving accounting standards are helping attract inbound fund investments into the Japanese market and are expected to drive an even greater influx of foreign capital in the years ahead.

Japan tax considerations for offshore fund investments

1. Permanent establishment rules and exemptions

Under Japanese domestic tax law, a non-resident — whether a corporation or an individual—with a permanent establishment (PE) in Japan is subject to Japanese tax on all income attributable to that PE.

In context of inbound investments, PE rules typically apply when a non-resident investor participates in either: (1) a Japanese Investment Business Limited Partnership (IBLP), or (2) a foreign fund that is directly managed from Japan, such as through a resident general partner, a resident limited partner with decision-making authority or dependent resident agents.

1.1 Permanent establishment

If a fund or any of its limited partners are deemed to have a PE in Japan, both the income recognized by the fund and any other income attributable to that PE would generally be subject to full Japanese tax rates.

Where the fund is treated as tax transparent and a PE is determined to exist, the applicable Japanese tax rate would be approximately 31%–34% if the fund and/or its limited partners are regarded as corporate entities, or up to 55.945% (including income surtax) for individual limited partners.

In addition, distributions from the fund to limited partners of profits allocable to the PE would generally be subject to Japanese withholding tax at a rate of 20.42% (including income surtax). Partners may claim a credit for their share of any such withholding tax against their Japanese tax liabilities related to the PE when filing their Japanese tax returns.

1.2 Permanent establishment exemptions

A non-resident investor may invest in an IBLP without creating a Japanese tax liability arising from a PE in Japan, provided certain requirements are met and a domestic PE exemption application is filed on time. These requirements include: the non-resident investor is a limited partner in the fund; does not participate in the fund's management; holds less than 25% in the fund assets, based on the higher of ownership interest or share in profits and losses; has no other PE in Japan (apart from any PE attributed through the limited partner interest); and is not a related party of the general partner.

2. 25/5 Rule and exemption:

In principle, a non-Japan resident investor (corporation or individual) is generally not subject to taxation in Japan unless the investor has a PE in the country, or, without a PE, becomes taxable under the 25/5 rule or the real estate holding company (REHC) rule.

2.1 25/5 Rule
A non-Japan resident investor without a Japan PE is generally not subject to tax on capital gains from the sale of shares in a Japanese company unless the investor, together with its special related parties, sells 5% or more of the company's shares in any fiscal year and has owned, or previously owned, 25% or more of its shares at any time during the fiscal year of sale or the preceding two fiscal years (the 25/5 Rule). Where the seller is a flow-through partnership for Japanese tax purposes, these 5% and 25% ownership thresholds are assessed at the partnership level (e.g., the fund) rather than at the level of each individual partner.

2.2 25/5 Rule exemption
The 25/5 Rule is, however, liberalized under the "25/5 Rule Exemption" for the sale of shares in Japanese companies by an IBLP or another foreign partnership fund similar to an IBLP, provided specific qualifying criteria are met. The exemption applies to transactions ("Covered Transactions") that (i) satisfy a one-year holding period requirement and (ii) do not involve the disposal of shares in certain distressed financial institutions or a REHC.

If a fund's investment in a Japanese company qualifies as a covered transaction, the 25% and 5% ownership threshold are tested at the investor level—if the following conditions are met:

(a) The investor (i) does not have a permanent establishment in Japan; (ii) is a limited partner in the fund; (iii) does not own 25% or more of the shares of the Japanese company sold; and (iv) is not involved in the fund's management or operation; and

(b) The investor files the required qualifying documentation with the Japanese tax authorities.

Transition from book value evaluation to fair value evaluation

1. Amendment of the Financial Instruments and Exchange Act and the Act on Investment Trusts and Investment Corporations (Unlisted Stock Incorporation) (May 2024):
In May 2024, amendments to the Financial Instruments and Exchange Act and the Act on Investment Trusts and Investment Corporations introduced a framework allowing mutual funds to invest in unlisted stocks.

1.1 Mutual funds can invest in unlisted stocks, with a limit of maximum 15%
The Financial Services Agency has stated that the framework is intended to enhance funding for startup companies, while also ensuring necessary safeguards and audit measures to address the higher risks and illiquidity involved. Although it allows a direct inclusion of unlisted stocks in retail investment trust products in Japan, most funds currently maintain only a very small allocation (typically less than 1%) to unlisted equities due to liquidity risk.

1.2 Fair value measurement to non-marketable equity securities
On 21 December 2023, the Investment Trusts Association, Japan, amended its rules to include audit considerations for

investments in non-marketable stocks and other securities. Unlisted stocks held by mutual funds are now evaluated at fair value in accordance with IFRS Accounting Standards and US GAAP. Fair value is generally determined using methods such as net asset value, comparison with similar listed companies, or guidance from the International Private Equity and Venture Capital Valuation (IPEV)guidelines.

2. Amendments to the Limited Partnership Act for Investments (LPS Act) (September 2024) and Practical Guidelines on Accounting for Financial Instruments (March 2025):
A limited partnership agreement (hereinafter, LPS) for investment in Japan is a legal contract that establishes an investment limited partnership under the LPS Act. This structure is commonly used for private equity and venture capital funds in Japan.

2.1 Deregulation of investment restrictions for foreign corporations
Investment in foreign corporations by LPS, previously limited to 50% of the total capital contribution of all partners, is exempted for foreign corporations effectively controlled by domestic business. This is expected to encourage capital inflows from overseas investors and promote the global business expansion of domestic Japanese business.

2.2 Fair value measurement to non-marketable equity securities
In Japan, non-marketable equity securities were traditionally valued at cost under Japanese GAAP. However, with the recent rise of financial products incorporating unlisted stocks into funds, more growth capital is expected to flow into venture capital investments. The revised Practical Guidelines on Accounting for Financial Instruments now allows investors to choose whether to value all non-marketable equity securities at fair value, depending on their accounting policy.

CONCLUSION

From a tax perspective, the Government of Japan has updated regulations to make the local asset management market more attractive to foreign investors. Exemptions from permanent establishment and 25/5 rules should provide greater access and alternative structure opportunities without triggering unexpected tax liabilities.

While the exemption requirements are not overly complex, they can affect fund structured operations, limiting limited partners' authority to decision-making. Investors should consider carefully both qualifying conditions and their impact on partners' intended roles.

Additional legal reforms aim to channel more capital into startups and expand investment options.

Due to the lack of market transactions, fair value for non-marketable securities must be determined using guidelines and valuation models, presenting unique challenges compared to listed stocks.

TO THE POINT

- Providing tax exemptions to permanent establishment and applying the 25/5 rules should increase foreign investors access to the Japanese market while enabling alternative structuring opportunities, without triggering unforeseen tax exposure in Japan. In addition, recent legal reforms on unlisted stock incorporation and limited partnership agreements—including the shift to fair value measurement of non-marketable equity securities—aim to channel more capital into startups and offer investors a broader range of diversified opportunities.

Tech Trends 2025: A Perspective For The Investment Management Sector

INTRODUCTION

Artificial Intelligence (AI) remains a focal point of discussion across the Investment Management industry. As highlighted in our Tech Trends 2025 report, we predict that AI is set to become an integral, unseen part of how the industry does business, and we see this AI-infused future across most of this year's six macro forces of information technology (IT). In this report, we will share our observations, experiences, and predictions from the Investment Management industry for each trend.

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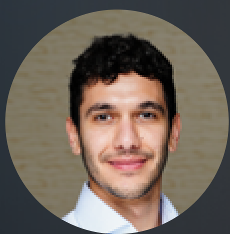

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AI
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1. Spatial computing: Metaverse meets finance

Spatial computing is an emerging technology within the Investment Management industry. Some investment managers are bullish and actively exploring it by building applications and experiences. For example, Fidelity Investments released an immersive metaverse experience, "The Fidelity Stack" 1. "The Fidelity Stack", The Fidelity Stack built in Decentraland, features a multi-level design complete with a lobby, dance floor, and rooftop sky garden for users to explore on foot – or through teleport. In the Invest Quest at The Fidelity Stack, users are challenged to traverse the building, learning the basics of ETF investing while gathering "orbs" along the way."1

Spatial computing applications exist across learning, client interactions, and wealth planning functions. Hyperpersonalized GenAI client experiences can be amplified through spatial computing. Imagine engaging with your financial advisor in a personalized space augmented reality—put on your virtual reality (VR) headset at home, work through wealth planning scenarios, and see your surroundings adjust as you interact with different levers. GenAI agents can generate images, voice, and text to create a tailored client experience.

Despite the potential, challenges include technical limitations (processing and battery life), data retention and privacy, ergonomic form factor, limited user access, and the need for skilled engineering talent.

2. Small Language Models (SLMs): Intelligent copilots

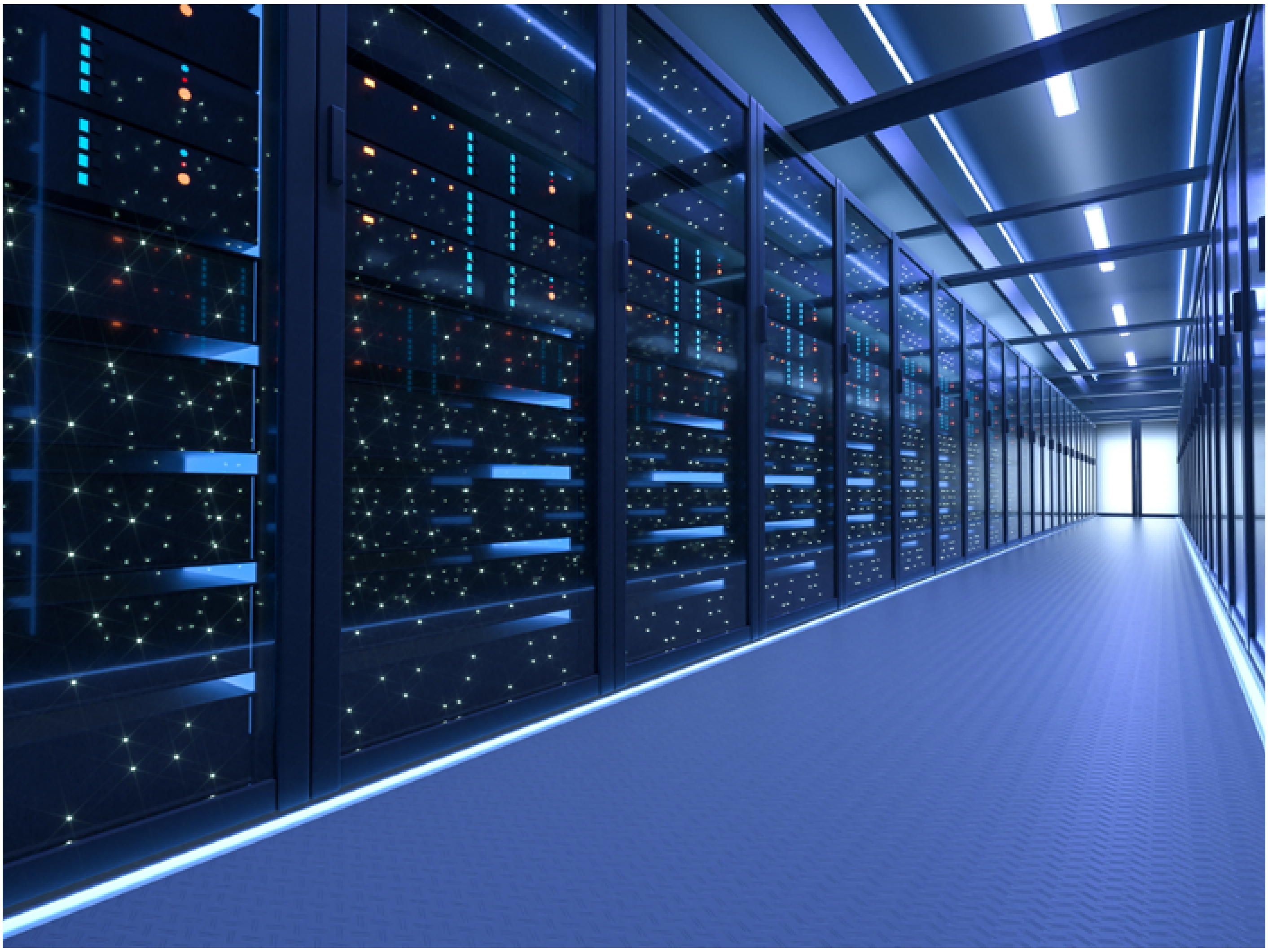
While large language models (LLMs) excel at quick insights on many topics, cases requiring specialized knowledge or unique terminology remain challenging to solve efficiently and cost-effectively. SLMs have advantages over LLMs by being efficient (lower resource needs, faster processing, lower latency) and having a more compact focus. "One such SLM, developed by Kohei Watanabe, a member of the Lazard Quantitative Equity team, is Latent Semantic Scaling (LSS). LSS is a semi-supervised document scanning technique that locates documents in any language on user-defined dimensions... [It] estimates the semantic proximity between words in the data, while the seed words define the dimensions of interest... In addition to being transparent—we can completely unpack and fully understand LSS outputs—this level of precision comes at a fraction of the cost if we were to attempt the same exercise using an LLM."2 The team leveraged LSS to gain insights from annual reports in Mandarin, identifying companies least impacted by the volatile Chinese housing market, without needing translation.

Other opportunities for SLMs in Investment Management include chatbots for proprietary analysis and financial documents, compliance tools trained on specific rules, and advisor assistants trained to understand financial data and concepts. As agentic AI transforms how we do work, SLMs will be instrumental to enable adoption at scale, with each agent being powered by an SLM specific to its unique tasks.

Adopting SLMs comes with challenges. Companies need to design a multi-agent architecture, where specialized SLMs are responsible for specific functions, similar to a microservices approach in software development. Ensuring accuracy and reliability through robust monitoring and data privacy guardrails will be crucial.

3. Hardware for AI: Powering the AI hungry future

Many technology teams at Investment Management firms have been focused on migrating from mainframes to cloud and are now revisiting their data/cloud strategy as AI becomes a competitive imperative. Investment managers should ensure that their data centers can support scaling AI infrastructure and energy needs. AI workloads demand low-latency, high-data-rate transfers and increased computational demands, requiring a shift to high-power, AI-ready infrastructure. Firms are investing in core infrastructure and partnering with leading providers to incorporate this trend into their investment theses. BlackRock, Microsoft, Global Infrastructure Partners, and MGX announced the Global AI Infrastructure Investment Partnership in September 2024, "with a goal of building the backbone of future AI infrastructure... [to] build data



centers and ... the supporting grid energy infrastructure to power them" 3. In the same month, "Blackstone, along with the Canada Pension Plan Investment Board (CPP Investments), agreed to buy AirTrunk ... the fastest-growing data center platform in the Asian-Pacific region."3

Other hardware advancements include laptops and desktops with AI chips and copilots built in, and futuristic screens for simulations and what-if scenario analysis.

Robust hosting strategies will likely become critical to balance on-premises solutions, hyperscalers, and emerging providers, which will help navigate regulatory, operational, and cost constraints.

4. Operating model: Next-gen engagement models

At many AI-pioneering investment managers, the AI agenda is driven by IT and Data, Analytics, and AI teams with business sponsorship. Early successes have elevated these teams to partners required to achieve AI-led transformation initiatives.

Investment managers are increasingly adopting modular and vendor-driven solutions that streamline operations and provide flexibility. Vendors like Aladdin and Charles River offer scalable platforms consolidating data from public and private markets. This can free internal business and technology/data teams to focus on non-commoditized aspects and become data-driven for agility, personalization, and operational efficiency. "As Vanguard CEO Tim Buckley and CIO Greg Davis explain, AI condenses earnings and research reports, enables faster and more accurate decisions, and simplifies advice. And that is only the beginning."4. To fuel these prospects, specialized tech talent is a must.

1 https://newsroom.fidelity.com/pressreleases/fidelity-opens--the-fidelity-stack--in-decentraland--becomes-first-brokerage-firm-with-immersive-edu/s/1b05ba31-ad92-4eee-84ef-bf298bb4c802

2 https://www.lazardassetmanagement.com/docs/-m0-/224625/inpraiseofsmalllanguagemodels_lazardperspectives.pdf

3 https://www.datacenterfrontier.com/hyperscale/article/55141302/blackrock-microsoft-nvidia-blackstone-and-the-future-of-global-ai-infrastructure-investment

4 https://corporate.vanguard.com/content/corporatesite/us/en/corp/articles/incorporating-ai-into-day-to-day.html

5 https://am.jpmorgan.com/us/en/asset-management/institutional/about-us/trusted-asset-manager/oversight/

6 https://www.statestreet.com/alpha/insights/artificial-intelligence

7 https://www.bloomberg.com/company/press/bloomberggpt-50-billion-parameter-llm-tuned-finance/

8 https://www.blackrock.com/aladdin/solutions/aladdin-copilot

As AI initiatives scale, IT teams will revisit their operating model through five pillars: Infrastructure, Engineering, FinOps, Talent, and Innovation. There will be a shift from human-in-charge to human-in-the-loop, transforming IT delivery. New roles like prompt engineers will expand, reshaping the talent mix. AI-driven automation could reduce business teams' reliance on IT. However, areas such as model risk management, monitoring, and LLM ops will become more prevalent, especially as AI regulations become clearer.

These shifts are essential for firms aiming to stay competitive and responsive to expanding the role of AI in meeting evolving client and stakeholder needs.

5. Cybersecurity: Cyber readiness for a post-quantum world

As Investment Management firms embrace innovations and gear up for the future, they must also adapt to new and evolving cybersecurity risks. While quantum computing is still emerging, it offers strong potential for evolving securities trading, optimizing fund asset management, and predictive analytics. However, as quantum computing adoption grows, so will concerns around data privacy and security.

While building quantum-secure protocols may not currently be top of mind, investment managers are prioritizing the maturity of their cyber programs. JP Morgan's Global Head of Cybersecurity Awareness Program emphasizes that "Building a united and secure oversight framework—across cybersecurity, risk management and business resiliency—is a top priority for our firm" 5. A well-defined roadmap to reach a post-quantum world is critical to ensure Investment Management technologies can continue to operate within privacy and security constraints.

6. Core systems: Platforms reinvented

2025 sees the rise of new GenAI features within core systems such as Trading, Customer Relationship Management (CRM), Human Resources (HR), and Finance. Within the front office, AI/GenAI capabilities are being released in Aladdin Copilot8 and Bloomberg GPT7. Asset servicers like State Street offer front-to-end solutions with AI embedded throughout the platform, offering AI-fueled "Front to back and AI in between" 6 solutions. There is also excitement around leveraging AI features from CRM and Finance/HR systems to transform how work gets done. Investment managers will likely need to update workflows to embed the full power of GenAI within these systems to achieve impact on their business.

Investment managers are integrating GenAI into their core systems, either by transforming existing systems or building new ones. They are using GenAI to develop the AI capabilities and/or migrate in-house systems and tools to a more modern tech stack. Many legacy systems lack documentation and experienced engineers, but AI-assisted solutions can help overcome these challenges at scale.

Investment managers must address the complexity of rolling out these features and ensure proper education on the technology and its limitations. Implementing controls, such as human-in-the-loop processes, ongoing monitoring, and prompt maintenance, is essential to safeguard GenAI deployments, especially for mission-critical core systems.

CONCLUSION

The AI landscape is rapidly evolving. For investment managers to take maximum advantage of new technology, timely adoption, building foundational capabilities, and training execution muscles will be key. As Investment Management firms further adopt AI, it will be increasingly important to balance the risks of the technology with the productivity and customer experience benefits. The spectrum of AI use cases will likely widen as the technology becomes more sophisticated. This evolution will further unlock AI solutions tailored to address the unique challenges and needs of the Investment Management industry.

TO THE POINT

The AI landscape is rapidly evolving, making timely adoption, development of foundational capabilities, and effective training essential for investment managers to drive efficiency, innovation, and enhance client experiences.

Small language models (SLMs) will be instrumental to balancing output efficiency, quality and costs. These agents can serve as highly effective Copilots with the potential to fundamentally transform how work is performed across the investment management organization, driving greater efficiency and innovation.

Modernizing operating models and talent strategies– including a shift toward modular platforms and implementing human-in-the-loop governance – will be key to maximizing AI's impact and your organization's agility.

Successfully navigating regulatory, operational and cost constraints will require a careful balance between on premises solutions, Cloud native/SaaS solutions, and FinTech software. This strategic approach will be key to optimizing performance while maintaining compliance and managing expenses.

Mitigating sanctions circumvention risks and strengthening global compliance

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Understanding the need for effective compliance with sanctions regimes

In complex global politics and international relations, sanctions regimes have become an important tool for countries seeking to influence the behaviour of other states without resorting to military actions. These measures can take various forms, from targeted sanctions and sectorial restrictions to comprehensive sanctions, and are often used to address issues such as armed conflicts, humanitarian concerns, or the proliferation of weapons of mass destruction.

The private sector, particularly the financial industry, plays a critical role in the implementation of sanctions as entities within this industry can have a view of the flows of funds which ultimately allow to prevent and detect illicit financial activities. Sanctions regimes continue to grow, along with related obligations and compliance controls required to detect and prevent their violations. In parallel, instances of sanctions violations and circumventions are regularly reported in official publications and the media.

This increases visibility of direct or indirect sanctions breaches naturally raises an important question: Should reported sanctions violations force us to question their effectiveness and how they are implemented?

Why should organizations prioritize compliance with sanctions regimes, detection of sanctions violations and circumvention?

Compliance with sanctions regimes is more than a legal obligation; it is an obligation to achieve a specific outcome, carrying significant consequences. Professionals must possess a thorough understanding of sanctions imposed by entities such as the European Union (EU), the United Nations (UN), the US and the UK, and implement appropriate controls tailored to the scope of their business activities. This emphasizes the importance of establishing an effective sanctions framework. Without it, organizations risk monetary penalties and reputational damage, as professionals remain accountable for any breaches arising from inadequacies in their framework.

The EU Directive 2024/1226 reinforces this framework by introducing criminal accountability for sanctions breaches caused by serious negligence. While Luxembourg has yet to implement this directive, its draft bill aims to broaden the scope to cover all restrictive measures, irrespective of their legal basis - not just the European sanctions regime.

Sanctions regimes should be upheld not only as a legal requirement but also because their historically proven effectiveness.

Economic sanctions played a pivotal role in securing Indonesia's independence from Dutch rule and were instrumental in the campaign that led to Nelson Mandela's release from prison. More recently, the economic challenges faced by Russia further illustrate the power of sanctions, as evidenced by the 2.1% decline in its GDP in 2022 and its comparatively weaker growth relative to other commodity exporters.

Although there are indications that some goods may have been diverted to Russia from other countries, the volume of these redirected goods remains well below pre-war export levels. The necessity for individuals and entities to navigate intricate procedures and adopt convoluted schemes to evade sanctions shows how impactful these measures are. Sanctions circumvention schemes have become so complicated and risky that they could ruin the financial gains they are meant to achieve.

Adapting sanctions frameworks to address emerging sanctions circumvention practices

According to a recent FATF report, the financial system remains highly vulnerable to the financing of prohibited activities. The ability of sanctions evaders to continuously adapt their methods poses a significant threat to the effectiveness of sanctions, enabling targeted individuals and entities to access global markets and fund illicit activities. Three examples include—but are not limited to—the following:

- **Russia's circumvention strategies towards standard financial systems' restrictions**

Russia has developed alternative strategies to sustain its economy and financial system:

1. **Physical cash transport:** Billions of dollars and euros have reportedly reached Russian banks, with substantial physical cash transported from countries like the United Arab Emirates and Türkiye. This has stabilized Russia's financial system and supported international transactions, often in exchange for precious metals.

2. **Currency swap agreements:** Russia has entered agreements with countries like China, facilitating trade and access to foreign currencies without relying on Western payment systems. Using Chinese banks, financial messaging systems outside SWIFT and alternative payment infrastructure, Russia has bypassed sanctions while maintaining strong bilateral trade with China.

3. **Use of cryptocurrencies and unregulated platforms and intermediaries:** In 2022, the Russian defense conglomerate (Rostec) announced a new digital payment system to replace SWIFT network and has since launched a rubble-pegged stablecoin for international transactions. Rosselkhozbank claimed to use cryptocurrency payments for grain settlements. Russia's security services are using crypto in their operations in Europe. A recent Reuters investigation found that crypto wallets were used to pay for intelligence and mis-information operations across Europe.

- **Oil cap's circumvention by Russia and North Korea**

Sophisticated tactics are also employed in evading oil cap restrictions placed on Russia and North Korea. Investigative reports reveal advanced smuggling practices, including:

1. **Ship-to-ship transfers:** The EU-sanctioned oil tanker Unica allegedly conducts ship-to-ship oil transfers in the Taiwan Strait before passing shipments to North Korean vessels within their territorial waters, circumventing the UN's 500,000-barrel cap imposed by Security Council Resolution 2397.

2. **Flag exploitation:** A UN report highlighted that North Korea uses flags from countries with lax vessel monitoring (e.g., Panama, Sierra Leone, and Tanzania) to disguise vessels. Cases of identity theft schemes involving blacklisted vessels were uncovered, deceiving commodity traders and obscuring the destination of shipments.

3. **Location faking:** Russian tankers reportedly falsify their geolocation, appearing west of Japan while shipping oil to China, allowing them to bypass the price cap and sell oil above sanctioned limits.

- **Dual-use goods smuggling to Iran**

According to the FATF, intermediaries and front companies have been used to supply dual-use goods to Iranian entities linked to nuclear weapon development. Such methods involve falsified trade documents and using third countries to obscure the final recipient, demonstrating the global reach and complexity of sanctions circumvention.

These examples demonstrate the need for heightened vigilance from the professionals and of substantial resource allocation, to adapt to complex sanctions circumvention schemes that undermine the effectiveness of the sanction's regimes.

How can organizations establish robust controls to detect and prevent attempts at sanctions circumvention?

Organizations play a pivotal role in detecting and preventing circumvention. To build a robust sanctions framework, three pillars are essential:

- **Sanctions-specific risk assessment:** A strong sanctions framework begins with business-wide risk assessments tailored to applicable sanctions obligations and the professional risks associated with sanctions violations. The extent of both is dependent on the professional's business products and services, counterparties and geographic exposure. It is recommended to make it a specific dimension that can be distinguished from the money-laundering (ML) and terrorism financing (TF) risks which the professional is exposed to.

As per the above-mentioned FATF report, the most common circumvention tactics are the **use of intermediaries, concealing beneficial ownership information**, the **use of virtual assets** and the use of the **maritime sector**. Consideration of FATF and other guidance documents help professionals to remain updated on emerging threats and to implement targeted risk mitigation strategies.

- **Counterparty due diligence:** Accurate identification of counterparties is critical for identifying sanctioned individuals or entities and understanding their business models. Proper due diligence that allows the identification and evaluation of sanctions must go beyond surface-level assessments, requiring expertise to examine intricate links between counterparties, especially when obscured through complex legal jurisdictions or falsified documentation. A **"one-size-fits-all" approach is insufficient**—counterparty diligence should be tailored to the risks posed by the business' activities.

- **Name screening processes:** Robust name screening mechanisms serve as the cornerstone of a sanction's framework. Unlike AML/CTF monitoring, screening for compliance with sanctions regimes is **rule-based**, requiring systems that can detect matches against official sanctions lists with precision and continuously. Professionals should implement:

1. Immediate updates to sanctions lists.

2. Verification procedures to ensure service providers update screening tools promptly.

3. Second level controls on sanctions alerts.

4. Immediate review and escalation of sanctions-related alerts to prevent detection delays.

Delays in updating sanctions lists or responding to alerts can result in late detection of sanctioned entities, which may trigger violations or breaches.

Lessons from the EU's comprehensive approach

Sanctions application is a collaborative effort that goes beyond the responsibilities of individual financial institutions. In response to the improvement of circumvention tactics, authorities worldwide are adopting multifaceted strategies to prevent circumvention and safeguard the integrity of sanctions frameworks. The EU's approach to Russian sanctions offers a prime example of how regulatory authorities are legislating to counter circumvention's trends effectively.

With 18 sanctions packages, the EU aimed at closing loopholes exploited by sanctions evaders, by targeting organizations beyond Russia, such as Chinese entities for supplying sensitive components to Russia's military, and by tightening export control measures involving companies in Serbia, Iran, India, and the United Arab Emirates for dual-use and advanced technologies. In response to evading the oil price cap, the EU also extended sanctions to specific vessels, an operator of an open flag registry and a captain. The strategic shift to secondary sanctions underscored the EU's commitment to combating sanctions circumvention by adapting its policies to address the complexities of global trade networks.

To combat sanctions circumvention, the EU has implemented extensive reporting requirements that provide national authorities with critical visibility into financial flows connected to Russian entities, such as:

- **Reports on fund transfers:** Legal entities with a direct or indirect ownership stake of more than 40% by Russian nationals, residents, or entities must report any fund transfers exceeding €100,000 from within the Union. Credit and financial institutions must submit reports on their clients meeting the same ownership criteria, allowing national competent authorities to evaluate risks more effectively and identify funds leaving the EU that might be connected to sanctions violations.

- **Reports on deposits:** The EU further seeks to close potential loopholes and thwart circumvention strategies that might compromise its regulatory framework by requiring reporting on deposits over €100,000 held by Russian nationals, entities established in Russia, or individuals residing in Russia. This also applies to entities whose proprietary rights are over 50% owned, directly or indirectly, by Russian nationals or residents, and individuals who have acquired citizenship or residence through investor programs in a Member State.

Authorities are sending clear and strong message that detecting and preventing sanctions circumvention is a key **responsibility for financial institutions but not limited to these**. While financial institutions play a critical role in monitoring and reporting, authorities rely on their cooperation to gain better visibility into transactions—but issues arise due to differing thresholds across sanctions regimes. For instance, the EU's ownership criteria for reporting (40% ownership stake and 50% proprietary rights) present challenges in aligning these requirements with Know Your Customer (KYC) processes.

This collaborative approach calls for alignment across public and private sectors being necessary to address the ever-evolving tactics of sanctions evaders.

Looking ahead, advancements like the adoption of emerging technologies, such as **artificial intelligence,** the progressive tightening of regulatory frameworks, **enhanced cross-border information-sharing** mechanisms, and **public-private partnerships** are paving the way for more robust and efficient compliance systems.

When designed with clear objectives, precise targeting, and robust frameworks, sanctions can drive positive change, promote accountability, and deter unlawful practices. **Effective sanctions implementation is not a one-person job, it depends on the collective will and vigilance** of governments, institutions, and professionals worldwide. By investing in **robust sanctions frameworks and staying ahead of evolving circumvention tactics**, we can ensure that sanctions remain a cornerstone of international justice, accountability, and peace, protecting our financial sectors and economies.

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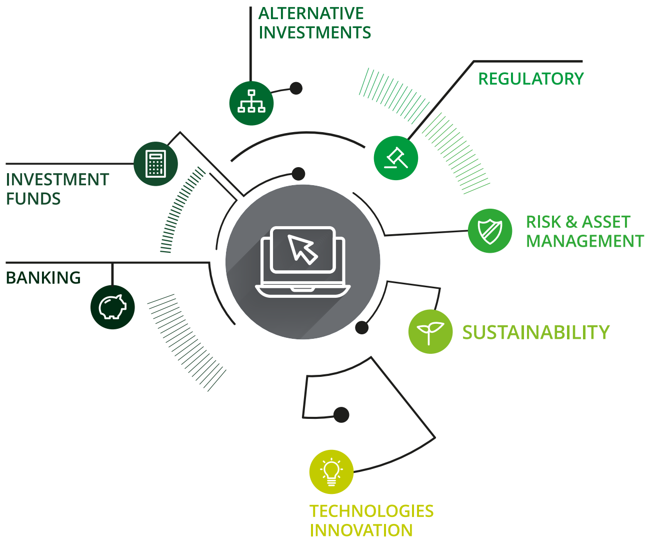

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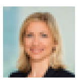
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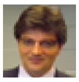
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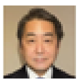
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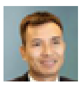
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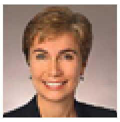

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