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Japanese Fund Regulatory Framework—2015 Amendment

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On March 24, 2015, an amendment bill ("Amendment Bill") to the Financial Instruments and Exchange Act of Japan ("FIEA") was approved by the Cabinet and was submitted to the Diet for its consideration. The Amendment Bill proposes several key changes; of particular interest is a proposed limit on the availability of a licensing exemption that a great number of partnership-type non-Japanese funds have relied on when offering those funds to Japanese investors.

It is anticipated that the Amendment Bill will likely pass during the Diet's current (January 2015) session, possibly with some minor changes. If enacted, the Amendment Bill will come into force within one year after it is promulgated. While we will need to wait until the bill passes, and the Japanese Financial Services Agency ("FSA") promulgates ordinances and rules thereunder to get a clearer picture of what the new regulatory framework will be, nonetheless, we anticipate that the amendments will bring some dramatic changes to the regulatory environment under which non-Japanese funds can be offered and sold to Japanese investors.

Background

Under Japanese law, applicable exemptions from licensing requirements for non-Japanese funds depend on both the type of securities offered and the type of entity issuing the security (i.e., corporation, investment trust, or partnership). The Amendment Bill will affect non-Japanese collective investment schemes that are partnership-type funds, typically structured as partnerships, limited partnerships, and limited liability companies ("LLC").

The concept of partnership differs under Japanese law as compared to US law), and funds that are not otherwise structured as partnerships under US law nonetheless may have to be treated as partnerships for the purpose of these Japanese regulations. For example, trusts may be partnerships, depending on the structure and types of assets in which they invest. Further, membership interests in LLCs, depending on the structure and the types of assets in which they invest, may be collective investment schemes, or other types of securities for the purpose of Japanese regulation. In any event, funds that already have Japanese investors may need to revisit their regulatory status by looking at prior filings (if any) to determine which exemption that the funds are relying on.

As a result of collapsing Japanese government bond returns, in recent months, Japanese insurance companies, pension funds, and investment trusts, along with the Japanese giant JPY127 trillion (USD1.06 trillion) public pension fund, Government Pension Investment Fund (also known as "GPIF"), are allocating more funds to non-Japanese funds. While we believe a significant volume of such investments are directed to US funds and non-Japanese funds managed by US investment managers, given the anticipated changes to Japan's fund regulatory framework, funds should carefully structure their deals in consideration of such changes.

Article 63 Exemption for Foreign Collective Investment Scheme—Current Regulatory Framework

Article 63 of the FIEA provides a special licensing exemption for certain activities of collective investment schemes (i.e., partnership-type funds), namely, "QII Specially Permitted Business" ("Article 63 Exemption"). A QII Special Permitted Business under Article 63 Exemption permits limited offerings to Japanese investors on a self-solicitation basis, and allows the management of certain collective investment schemes. By relying on the Article 63 Exemption, non-Japanese collective investment schemes can offer their interests to Japanese investors without having to register as Type II dealers on a self-solicitation basis by a general partner of a limited partnership or a managing member of a non-Japanese collective investment scheme, and can manage these funds without having to register as investment managers on a self-management basis.[1]

Article 63 Exemption is available when the offering is made (a) by way of a private placement and (b) on a self-solicitation basis, provided that the following conditions are met:

(i) The investors in the fund include at least one qualified institutional investor ("QII") within the meaning of FIEA;[2]

(ii) the number of Japanese non-QII investors (who have acquired the interests in the fund, as opposed to the number of offerees) is 49 or fewer;

(iii) offering documents include certain offering restrictions; and

(iv) prior to any offerings to Japanese investors, a notice must be filed with the Kanto Local Finance Bureau of Ministry of Finance. The notice is not made public, other than with respect to certain items, such as the name of the fund.

Article 63 Exemption, which can only be employed when a solicitation is carried out by officers or employees of a general partner or a managing member, is a widely used exemption for both Japanese and non-Japanese funds. It has been reported that there are approximately 3,000 funds (including Japanese funds) that currently rely on Article 63 Exemption.

Anticipated Changes to Article 63 Exemption under the Amendment Bill

The key proposed changes to Article 63 Exemption (licensing exemption for collective investment schemes (i.e., partnership-type funds)) include:

- Limited availability of the exemption: The Amendment Bill proposed to significantly limit the availability of Article 63 Exemption.

[1] Non-Japanese collective investment schemes may rely on a different exemption to investment manager licensing provided that (i) all the Japanese investors are QIIs, (ii) the number of Japanese QIIs is fewer than 10, and (iii) the total contribution from Japanese QIIs consists of less than one third of the total contribution to the fund.

[2] QIIs are certain investors who have requisite professional knowledge and experience relating to investment in securities, as defined in Article 2(3) of the FIEA and Article 10(1) of the Cabinet Office Ordinance regarding Definitions under Article 2 of the FIEA. The FSA maintains and periodically updates the list of institutional as well as individual QIIs, which can be found here: http://www.fsa.go.jp/common/law/tekikaku/index.html (only in Japanese).

        - The Amendment Bill proposes to disqualify certain funds from relying on Article 63 Exemption. These funds include, notably, non-Japanese funds that do not have a representative in Japan.

        - Under the Amendment Bill, the current required prior notice to the regulator will have to be accompanied by additional corporate documents, to be detailed in the FSA ordinance. Further, notices will be disclosed by the regulator, and notificants will be required to disclose notices filed in a manner to be specified.

        - Eligible non-QII investors will be limited to certain sophisticated investors and persons related to the funds, with exceptions for certain venture capital funds that satisfy certain requirements including having required internal governance structure and accounting audit by certified public accountants.

    - Increased activity restrictions: funds relying on the Article 63 Exemption will have to comply with certain activity restrictions applicable to Japanese registered dealers and investment managers. For example, the funds will be subject to regulations related to suitability requirements, delivery of required notices, requirements for advertisement, and segregation of investor funds.

    - Introduction of bookkeeping and an annual reporting obligation to the regulator.

    - Increased oversight by the regulator, including permitting the regulator to require submission of contracts between the funds and investors (e.g., partnership agreements and trust agreements).

    - Providing for increased penalties for noncompliance.

Under the Amendment Bill, existing funds that have filed notices pursuant to Article 63 Exemption under the current FIEA to manage investments without registering as investment manager may continue managing the fund assets by relying on the Article 63 Exemption until the termination of the investment schemes. However, those existing funds would have to comply with portions of the revised Article 63 regulation including, for example, the new bookkeeping and reporting obligations and, more importantly, the requirement for non-Japanese funds to have a representative in Japan. As currently drafted, the Amendment Bill will postpone the application of the local-presence requirement to existing funds for six months after its effective date. However, after the expiration of the six-month period, each existing fund will be required to arrange for a representative in Japan.

We anticipate that more details regarding the new regulatory framework will be supplied via FSA ordinances promulgated once the Amendment Bill passes at the Diet. Further, the Amendment Bill expressly delegates FSA the authority to adopt ordinances to determine how the new regulatory framework will apply to non-Japanese funds.

We will continue to monitor the progress of this bill. Please contact your K&L Gates attorney for more information.

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