New Japanese regulations for fund type investment schemes

The 2006 *Financial Instruments and Exchange Law* now regulates investments in Japanese companies made through partnership interests. Noritaka Niwano of Anderson Mori & Tomotsune explores the implications of the new law, which has increased scope and includes disclosure requirements for some collective investment schemes.

By Noritaka Niwano
Anderson Mori & Tomotsune

Introduction

When investors consider investing in Japanese companies, one of the alternative schemes often utilized is to form a partnership and invest through partnership interests. This type of investment structure used to be unregulated under Japanese securities law. However, in June 2006, the new securities law was enacted, bringing such partnership fund type investments under the regulations of the new legislation. The new law has reorganized the existing *Securities and Exchange Law* (SEL) into the *Financial Instruments and Exchange Law* (FIEL). The FIEL became effective on September 30 2007. It has expanded the scope of regulated financial products (i.e. securities) and has increased its coverage to include activities that the SEL used not to cover. As a result, for interests in so-called "collective investment schemes", self-offerings (offerings of interests in a collective investment scheme by a general partner of the fund) and self-management (management of the assets held by the collective investment scheme by a general partner of the fund) have also become subject to regulations pertaining to certain activities. Additionally, collective investment schemes may also be subject to certain disclosure requirements.

Under the FIEL, any party who is involved in a financial instruments business (including, among other things, a business concerning securities) is required to register with the competent Local Finance Bureau. There are four types of financial instruments business:

(i) the "first financial instruments business", relating to business in securities with relatively high liquidity (i.e. government bonds and listed securities);
(ii) the "second financial instruments business", relating to business in less-liquid securities (i.e. trust beneficial interests, partnership interests, and *tokumei kumiai* interests);
(iii) an "investment advisory and agency business", relating to advisers and agents that provide nonbinding advice; and
(iv) an "investment management business", relating to managers that have the right to manage the relevant assets on a discretionary basis.

For collective investment scheme interests, self-offering will be included in (ii) and certain self-management falls under (iv). Therefore, both are new businesses to be regulated as a financial instruments business, and thereby, requiring registration. However, there are certain exemptions to the registration requirement.

Exemption to the registration requirement regarding self-offerings

(i) Exemption by outsourcing

The Financial Services Agency, via the answer to the public comments regarding subordinated regulations under the FIEL announced on July 31 2007, has clarified that registration as to solicitation activities is not necessary when a Fund entrusts solicitation of its interests to a third party and does not solicit at all on its own. This would not be considered as a self-offering in Japan.

(ii) Qualified Institutional Investors exemption

In the case of a self-offering of interests in a fund satisfying the conditions below, the FIEL does not require the fund to be registered. Instead, the fund is required to file a simple notification (the Notification of QII Exemption) in advance to the regulators of certain information such as the trade name and the address of the head office of the fund or its general partner.

(a) The self-offering is made to at least one Qualified Institutional Investor (QII) and to less than 50 investors who are neither QIIs nor persons that fall under the relevant regulation's definition of excluded QIIs (such investors, collectively with such QII, "QII, etc."); and
(b) The self-offering satisfies the following conditions in the cases described:
    (1) In the case where the acquirer of the interests is a QII (not including the excluded QIIs), a transfer restriction

that that QII can transfer the interests only to other QII(s) must be provided in contracts or other transactional documents with respect to the interests;

(2) In the case where the acquirer is an investor other than a QII (not including the excluded QIIs), a transfer restriction that the acquirer cannot transfer the interests except for the transfer of all of the interests to another party at once in a single transaction must be provided in contracts or other transactional documents with respect to such interests, and, if the issuer has issued the similar interests within six months before the date when such interests are issued, the total number of investors, other than a QII, acquiring interests in all the issued interests (including "similar interests") must be less than 50.

One thing to note is that Qualified Institutional Investor is a defined term under the FIEL, and most Japanese financial institutions (and non-Japanese financial institutions registered or licensed in Japan) are automatically included in the definition. However, other Japanese and non-Japanese entities (even if they are a financial institution) are not necessarily automatically within the definition of a QII. In order to be a Qualified Institutional Investor, the investor needs to file a notice, with the notice being effective for two years.

Exemption to the registration requirement regarding self-management

There are several exemptions from the registration requirement in connection with self-management. Among other things, the following are the noteworthy exemptions:

(i) Foreign fund exemption

If the fund is mainly invested in by foreign investors and involvement of Japanese investors is limited, the FIEL does not require the registration as an investment management business. More specifically, a management business which satisfies all the conditions described below will be exempt from the registration requirement:

(1) The direct Japanese investors (residents of Japan who hold the relevant interests) are QIIs or firms that filed a Notification of QII Exemption (as referred to above);

(2) The indirect Japanese investors (residents of Japan who hold collective investment scheme interests with respect to the relevant rights, excluding the rights under the laws of foreign countries) are QIIs;

(3) The total number of direct and indirect Japanese investors is less than 10; and

(4) The total amount of money and other assets invested or contributed from the direct Japanese investors does not exceed one-third of the total amount of money and assets invested or contributed from all the investors (Japanese and otherwise) of the relevant fund.

(ii) QII exemption

In the case where a fund manages money and other assets invested or contributed from only a QII (not including the excluded QIIs) which holds collective investment scheme interests, the FIEL does not require such a fund to register its business as an investment management business, and it is only required to file a notification in advance to the regulators of certain information, such as the trade name and the address of the head office.

Practical points regarding transfer restrictions

As mentioned above, one of the elements needed in order to meet the requirements of a QII Exemption is a transfer restriction of the interests in the collective investment scheme. However, the FIEL does not specifically deal with the circumstances involving non-Japanese investors. Here, a Japanese investor includes individuals who are residents of Japan and other legal entities formed under the laws of Japan.

One of the elements needed in order to meet the requirements of a QII Exemption is a transfer restriction of the interests in the collective investment scheme. However, the FIEL does not specifically deal with the circumstances involving non-Japanese investors.

As mentioned above, there are two types of transfer restrictions (a "QII only" restriction and an "all to one person at once in a single transaction only" restriction). When the first acquirer is a Japanese investor, the acquirer is, of course, subject to such transfer restrictions regardless as to whether the transferee is a Japanese investor or not. Further, the transferee, whether a Japanese investor or not, would also be subject to the same transfer restrictions.

One issue, then, is what if the first acquirer is a non-Japanese investor? If the first acquirer is a non-Japanese investor and a QII, then the acquirer is subject to QII only restrictions. If the first acquirer is a non-Japanese investor and not a QII, under Japanese law, there will be no transfer restrictions on such acquirer or on any subsequent acquirers so long as the interests are held by non-Japanese

investor(s). Further, such transfer restrictions would not apply even when the interests are transferred thereafter to a Japanese investor. However, the fund manager should bear in mind that, in order to obtain and maintain the QII Exemption, one of the requirements is that the number of non-QII Japanese investors totals less than 50. If the number reaches 50 by such a transfer of interests from a non-Japanese investor to a Japanese investor, the QII Exemption status will be lost. Therefore, the partnership agreement usually has certain monitoring and controlling mechanisms allowing the general partner to reject, if necessary, the transfer of the interests from non-Japanese investors to Japanese investors.

Practical points in making the solicitation

Another practical point would be the timing of filing a Notification of QII Exemption and commencing solicitation of investors (QIIs and non-QII investors). As mentioned above, the Notification of QII Exemption needs to be filed in advance of commencing the solicitation. However, before commencing the solicitation, the issuer would not have secured any QII investor or can be sure of doing so. Therefore, the question arises of whether the Notification of QII Exemption can be filed before securing at least one QII which will invest in the collective investment scheme.

> Under the FIEL, different disclosure requirements apply depending on the types of securities following the expansion of the scope of the concept of "securities".

The Financial Services Agency, via the answer to the public comments regarding subordinated regulations under the FIEL announced on July 31 2007, has clarified that the Notification of QII Exemption can be filed before securing a QII, and solicitation can be commenced both for QIIs and non-QII investors. However, the Financial Services Agency also pointed out that if the issuer (i.e. the fund or its general partner) cannot eventually secure at least one QII, the Notification of QII Exemption will become ineffective, and the solicitation to non-QII investors would retroactively become illegal.

Therefore, in practice, in order to avoid any risk in regulatory compliance, the Notification of QII Exemption should be filed first (the name of the relevant, or any, QII is not required to be stated), and then the issuer should attempt to secure at least one QII which will invest in the collective investment scheme (that is, they should solicit only QIIs at this stage). Only after securing such QII should the issuer commence solicitation of non-QII investors.

Disclosure requirements

Below is a summary of certain disclosure requirements to which the collective investment scheme may be subject.

Under the FIEL, different disclosure requirements apply depending on the types of securities following the expansion of the scope of the concept of "securities". In principle, the collective investment scheme interests are not subject to these disclosure requirements, except in the following circumstances:

(i) The disclosure requirements apply to collective investment scheme interests with respect to a fund investing in securities in amounts greater than 50% of the aggregate amount of money and other assets invested by or contributed from that fund's investors. In other words, if 50% or more of the money and assets are invested in non-securities, the collective investment scheme interests are not subject to a disclosure requirement.

(ii) If the above-mentioned standards are met, the following disclosure requirements would apply:

(a) In cases where not less than 500 persons acquire such interests (securities) by accepting the solicitation of the offeror, this is considered a "public offering" and therefore, a securities registration statement must be filed for the offering and continuous disclosure requirements, such as filing of annual securities reports, will apply thereafter. (These 500 persons are counted not on a solicitation basis, but on an actual acquisition (purchase) basis.)

(b) In cases other than the above (that is, in cases where there are less than 500 acquirers of the interests), this is considered a "private placement" and, therefore, the disclosure requirements do not apply; however, the offeror must notify investors to that effect and issue a written document thereupon.

About the author

Noritaka Niwano is attorney-at-law and a partner with Anderson Mori & Tomotsune in Tokyo.