西村あさひ法律事務所

NISHIMURA & ASAHI

Financial Regulation Newsletter

Client Alert: Proposed Stricter Requirements on QII-targeted Business Exemption in Japan

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1. Introduction

On March 24, 2015, a bill (the "**Bill**") to amend the Financial Instruments and Exchange Act (the "**FIEA**") such that it imposes stricter regulation over the QII-targeted business exemption (i.e. the "**Article 63**" exemption)(the "**Exemption**") was published and submitted to the Japanese Diet as part of the Financial Services Agency's (the "**FSA**") recent drive to improve the relevant legislation and regulations.[1] If the Bill passes and becomes law, foreign investment management firms presently benefiting from the Exemption may face a greater burden. The proposed new requirements are outlined in the following sections.

2. Background

Under the FIEA, unless an exemption applies, the general partner ("**GP**") of a limited partnership ("**LPS**") that mainly invests in securities is, in principle, required to be registered as both: (i) a financial instruments business operator ("**FIBO**") conducting "type II financial instruments business" ("**Type II FIBO**"), in respect of marketing interests in an LPS to Japanese investors or in Japan; and (ii) a FIBO conducting "investment management business" ("**IMBO**"), in respect of managing investments of an LPS that accepts a Japanese investor as a limited partner.

The Exemption allows a GP to conduct marketing activities and investment management activities for the LPS without being registered as either a Type II FIBO or an IMBO. To rely on the QII-targeted business exemption, the GP must both comply with the following requirements and also file a short-form notification called a "Form 20" ("**Form 20 Notification**") with the relevant authority before marketing to Japanese investors. In the case of a foreign GP, the relevant authority is the Kanto Local Finance Bureau (the "**KLFB**").

The current requirements for the Exemption are: (i) there must be at least one Qualified Institutional Investor (*tekikaku-kikan-toshika*) ("**QII**") in the LPS; (ii) there may not be more than 49 non-QII Japanese investors; (iii) there must be no "Disqualified Persons" as set forth under the FIEA, such as a fund of funds, special purpose company or

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other collective investment scheme (with certain exceptions); and (iv) transfer restrictions must be in place under which (a) a QII may not transfer its interests except to another QII and (b) a non-QII may not make a transfer other than a transfer of its entire interest to a single transferee.

Until the present, many foreign general partner entities have filed a Form 20 Notification to rely on the Exemption as simple and cost-effective measure. Given, however, that the Exemption is sometimes exploited in order to swindle investors, the FSA has, despite resistance from the investment management industry, been considering tightening the relevant regulations for more than one year. In January, the Financial System Council, an advisory body to the FSA, published a working group report (the "**January Report**"), which set out the key features of the Bill.

3. Narrower Scope of Non-QIIs Covered by the Exemption and Stricter QII Requirements

One of the suggestions presented in the January Report is to limit the scope of non-QIIs covered by the Exemption. The FIEA defers the determination of the scope of non-QIIs to the relevant cabinet order, and the currently applicable order imposes no limitation on the scope. An upcoming cabinet order is expected to address this recommendation. The January Report proposes excluding from the scope of the Exemption funds which evade the intent of the law by, for example, formally satisfying its requirements using a QII closely related to the GP and, in response thereto, the Bill includes technical amendments, which would allow the relevant cabinet office ordinance to facilitate the closure of loopholes. Draft amendments to the cabinet order and cabinet office ordinance have not yet been published and will only be available after the Bill is passed by the Diet. Considering, however, that foreign investment management firms mainly target banks, insurance companies and other sophisticated institutional investors, most of which are considered QIIs, it is expected that these amendments would not materially affect their marketing activities in Japan.[2]

4. Stricter Qualification Requirements for Exempted Operators

Any person (whether individual or corporate) can now rely on the Exemption and thereby conduct marketing activities and/or investment management activities (such person is hereinafter referred to as a "**Exempted Operator**"). However, the Bill proposes excluding certain persons from becoming Exempted Operators, such as certain types of ex-convicts, those whose financial business license has been revoked under the FIEA in the past five years, etc.

As for foreign GPs, the Bill requires that they appoint a representative in Japan. While this proposed provision requires further clarification, it is potentially an obstacle for foreign Exempted Operators with no local representatives in Japan.[3]

Please note that most of the new qualification requirements would also apply to existing Exempted Operators who have already filed a Form 20 Notification, either upon the implementation thereof or after a grace period of between six months and five years.

5. Greater Number of Attachments to Form 20 Notification

Currently, in the case of foreign GPs, a Form 20 Notification need only be accompanied by a simple affidavit. The Bill would require, in addition, submitting a letter stating that the GP meets the qualification requirements (together with its articles of incorporation and, in some cases, the relevant limited partnership agreement(s) as well). Existing Exempted Operators would likewise be required to submit similar documents within a grace period of six months.

6. Conduct Requirements Equivalent to Those Now Applicable to Registered Operators

While the current FIEA imposes only a few conduct requirements on Exempted Operators, the Bill intends to add more stringent conduct requirements, including most of those now applicable to Type II FIBOs and IMBOs. The new conduct requirements are summarized below:

- Regulations on advertising;
- Obligations to prepare and deliver explanatory documents in the manner provided in the FIEA;
- Suitability requirements;
- Obligations to prepare and deliver a management report on a biannual basis or more frequently in the manner

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provided in the FIEA;
- Segregation requirements for assets;
- Requirements on conflict-of-interest transactions;
- Other requirements targeted at investor protection.

Exempted Operators who only solicit and accept QIIs and other "Professional Investors" (*tokutei-toshika*) would be exempt from at least the first three items listed above.

These requirements would also apply to existing Exempted Operators with no grace period.

7. New Disclosure Requirements

The FSA is now making available a list of Exempted Operators on its website, which at present includes only their names and the date on which they filed their Form 20 Notifications. After the Bill passes and becomes law, the FSA would be required to make available to the public a part of the content of the filed Form 20 Notifications, including those filed by existing Exempted Operators, some of which may be added to the list on the FSA's website.

Further, Exempted Operators would be required to make available to the public a part of the content of their Form 20 Notifications at their relevant offices or on their own websites. This would also apply to existing Exempted Operators and there would be no grace period to comply with this new requirement.

The part of the content of the Form 20 Notifications that would be subject to the new disclosure requirements is, in each case, to be determined by the relevant cabinet office ordinance after the Bill is passed by the Diet.

8. New Reporting/Record-Keeping Requirements

The Bill also introduces new ongoing reporting and record-keeping requirements for Exempted Operators. Exempted Operators would be required to prepare and maintain records about their marketing activities and/or investment management activities and prepare annual business reports to file with the applicable authority on an annual basis. The details as to what information must be included in the records and reports are to be provided by the relevant cabinet office ordinance after the Bill passes.

Further, Exempted Operators are to make a part of the content of their recent annual business reports available to the public at their relevant offices or on their websites.

These requirements would also apply to existing Exempted Operators with no grace period.

9. Extended Enforcement Powers

The Bill intends to strengthen the regulators' ability to supervise Exempted Operators and take various enforcement actions against them, such as orders to improve their business operations, to suspend all of or a part of their business operations, or abolish their business operations. The regulators would also have authority to demand necessary reports or any relevant materials from Exempted Operators and/or their delegates (whether appointed directly or indirectly by them) and/or an on-site inspections of their or their delegates' relevant offices. The Bill also facilitates petitioning by the regulators to the court for an injunction against harmful marketing activities.

The Bill provides penalties for violations of the new requirements and also strengthens certain existing penalties.

10. Expected Timeframe

Considering that legislative amendments such as these are likely to receive the support of a majority in the Diet, unless there is powerful lobbying against the Bill, it is likely to be passed by the Diet in May or June 2015. In that case, as the amendments will take effect within one year of the Bill's becoming law, the amended FIEA, together with the related amendments to the cabinet order and cabinet office ordinance, would be expected to be implemented by April or May 2016, assuming the FSA adheres to its typical timeframe.

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11. Conclusion

The new regulations proposed by the Bill would significantly increase Exempted Operators' regulatory burden and associated costs. Therefore, Exempted Operators may wish to check whether they actually need to continue to rely on the Exemption after the Bill passes and becomes law.[4]

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[1] Each foreign entity that has filed Form 20 Notifications with the KLFB to rely on the Exemption should check whether it has received a letter from the KLFB, as the KLFB has recently issued reporting orders to most foreign filing entities. Please note that if an entity which is subject to a reporting order fails to submit a report by the deadline, the FSA may well add the entity to a blacklist available on its website.

[2] After the amendments, GPs that accept non-QIIs outside the scope of the Exemption or do not satisfy the stricter QII requirements will not be allowed to rely on the Exemption. Nonetheless, they will be grandfathered-in and will be able to continue relying on the Exemption so long as the offering of the relevant fund has commenced before the amendments take effect. Please note, however, that many other new requirements and obligations will be imposed either immediately on the effective date or after a grace period as outlined in the following sections.

[3] Further, the Bill introduces a new requirement related to international cooperation and information exchange among financial supervisors and regulators, under which foreign GPs domiciled or operating in any jurisdiction whose regulatory authority has not signed the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (the "**MMoU**"), or an equivalent bilateral agreement with the Japanese government, would be excluded from the Exemption. Considering, however, that almost all of the jurisdictions commonly selected by foreign GPs (such as the Cayman Islands) have signed the MMoU, this new requirement is not expected to have a material impact on most of such GPs.

[4] For example, if a foreign investment management firm intends to conduct only marketing activities aimed at certain Japanese financial institutions, via e-mail, telephone, video conference or other remote communication tool, from outside Japan, a combination of the so-called foreign broker-dealer exemption and the so-called de-minimis exemption would be a viable alternative in some cases.

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