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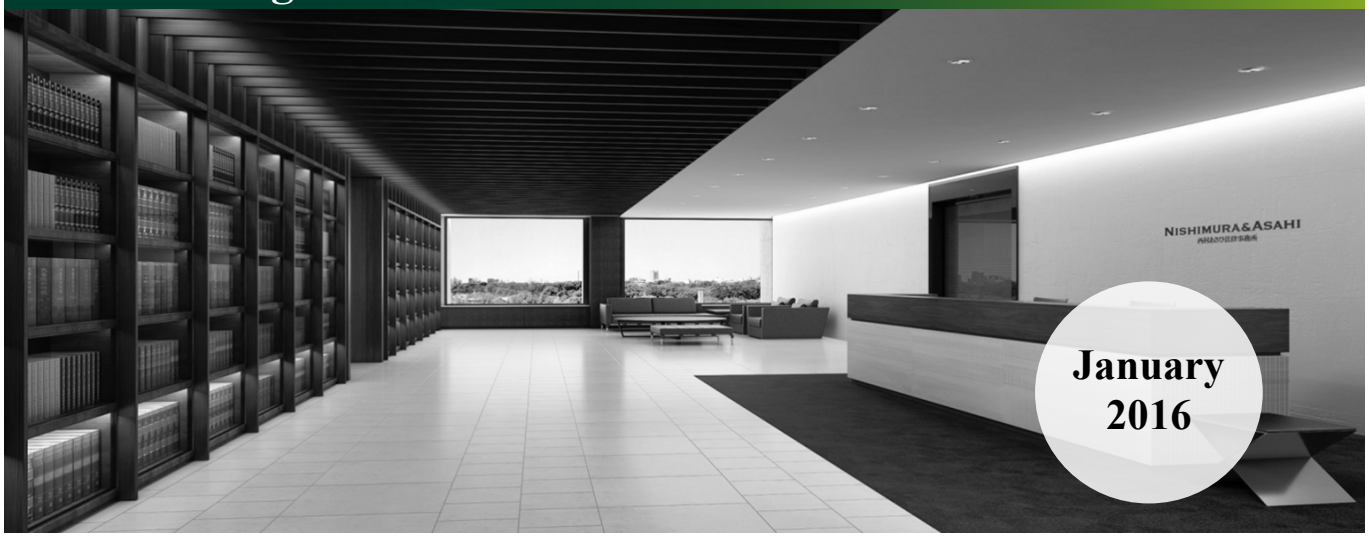
NISHIMURA & ASAHI

Financial Regulation Newsletter



Client Alert (New Update with Details):
Proposed Stricter Requirements on QII-targeted Business Exemption in Japan - Draft Detailed Regulations Published by the Financial Services Agency

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1. Introduction

On May 27, 2015, a bill (the "**Bill**" or the "**New Act**") to amend the Financial Instruments and Exchange Act (the "**FIEA**") to impose stricter regulation over the QII-targeted business exemption (i.e., the "**Article 63**" exemption) (the "**Exemption**") was passed without amendment by the Japanese Diet. The New Act reflects the recent drive of the Financial Services Agency (the "**FSA**") to improve the relevant legislation and regulations. Upon the New Act's entry into force, which is expected to occur sometime between February and April of this year, foreign investment management firms presently benefiting from the Exemption may face a greater burden.

Following publication of our brief newsletter article[1] on the Bill last April, the FSA published draft amendments to the relevant cabinet order and cabinet ordinance (the "**Draft Amendments**"), which revealed the details of the proposed new requirements, posting them for public comment on November 20, 2015. Thus, we have prepared the explanation below to cover those developments and provide general guidance for foreign general partner entities that have filed, or intend to file, a Form 20 Notification in reliance on the Exemption.

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 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 a simple and cost-effective measure. Given, however, that the Exemption is sometimes exploited in order to swindle investors, the FSA had been considering tightening the relevant regulations for more than one year before bringing the Bill to the Diet.

3. Narrower Scope of Non-QIIs Covered by the Exemption

One of the key features of the New Act 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 that scope. According to the Draft Amendments, however, the scope of non-QIIs covered by the Exemption will generally be limited to the categories below. (Please note that any investor that is a QII will continue to be regarded as a QII, regardless whether that investor falls under any of the categories below.)

(*i*) the following types of investors who are typically expected to be highly capable of making investment decisions:
- (*a*) The Japanese government.
- (*b*) The Bank of Japan.
- (*c*) Local governments.
- (*d*) FIBOs and Registered Financial Institutions (and, if they are legal entities, their subsidiaries and affiliates).
- (*e*) Individuals or legal entities that conduct private placement business or investment management business for collective investment schemes (including general partner entities).
- (*f*) Companies issuing shares listed on any Financial Instruments Exchange (and their subsidiaries and affiliates).
- (*g*) Legal entities with a stated capital of JPY 50 million or more (and their subsidiaries and affiliates).
- (*h*) Legal entities holding net assets of JPY 50 million or more (and their subsidiaries and affiliates).
- (*i*) Legal entities established by a special action under a special law (into which certain government-affiliated corporations and independent administrative agencies are categorized).
- (*j*) Specified Purpose Companies (*Tokutei Mokuteki Kaisha*, or "*TMK*").
- (*k*) Corporate Pension Funds holding financial assets invested in securities, derivatives and certain other financial instruments, the amount of which is reasonably expected, based on the surrounding circumstances, to be JPY 10 billion or more.
- (*l*) Foreign legal entities.
- (*m*) Individuals or legal entities that satisfy either of the following requirements:
  - (*x*) the individual or entity in his/her/its personal capacity (*i.e.*, not in his/her/its capacity as a general partner of a fund) both (A) holds financial assets invested in securities, derivatives and certain other financial instruments, the amount of which is reasonably expected, based on the surrounding circumstances, to be JPY 100 million or more, and (B) has maintained an account for securities or derivative transactions with a FIBO or Registered Financial Institution for one year or more; or
  - (*y*) the individual or entity acts as a general partner of a fund[2] and in his/her/its capacity as general partner holds financial assets invested in securities, derivatives and certain other financial instruments of the fund, the amount of which is reasonably expected, based on the surrounding circumstances, to be JPY 100 million or more.
- (*n*) Issuers of certain foreign collective investment schemes.
- (*o*) Certain other legal entities.

(*ii*) the following types of investors who are considered to have a close relationship with the GP:

(*a*) Direct or indirect parent companies, subsidiaries and affiliates of the GP.

(*b*) Individuals or legal entities to which the GP has delegated, in whole or in part, its discretionary investment management authority for the LPS.

(*c*) Individuals or legal entities which have entered into an investment advisory agreement with the GP in order to provide non-discretionary investment advisory services for consideration.

(*d*) Directors, officers or employees of the GP or any of the persons or legal entities listed in (*a*) to (*c*) above.

(*e*) Spouses and certain other relatives of the GP or any of the persons listed in (*b*) to (*d*) above.

Please note that this list is a summary of the proposed scope of non-QIIs covered by the Exemption and, therefore, should not be taken as a comprehensive and definitive list. Further, the scope of non-QIIs will be extended if certain requirements are met. However, considering 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 will not materially affect their marketing activities in Japan.[3]

4. Narrowing the Scope of Funds that May Rely on the Exemption

The following two types of funds, though they may up until now have formally satisfied the requirements of the Exemption, will be excluded from the Exemption's scope once the new regulations are implemented:

- Any fund in which there is no QII other than a QII that is a Japanese Investment Limited Partnership that only holds assets[4] (minus loans) the amount of which is reasonably expected, based on the surrounding circumstances, to be less than JPY 500 million.
- Any fund in which certain types of investors (including those which are typically considered as having a close relationship with the GP)[5] have contributed 50% or more of the capital of the fund.

In addition, if all the QIIs investing in a prospective fund are either subsidiaries of or controlled (in a certain specified manner) by the GP, the GP will be regarded as conducting the exempted business inappropriately and prohibited from forming the fund.

5. Stricter Qualification Requirements for Exempted Operators

Presently, any person (whether an individual or corporation) who qualifies for the Exemption can thereby conduct marketing activities and/or investment management activities (such a person is hereinafter referred to as an "**Exempted Operator**"). However, the New Act will exclude certain kinds of persons from becoming Exempted Operators, including 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 Exempted Operators, the New Act requires that they appoint a Japanese resident as a representative in Japan. Since such local representative seems to be primarily expected to act as a liaison between the Exempted Operator and the Japanese regulator, the representative would not necessarily need to be an insider of the Exempted Operator. Accordingly, foreign Exempted Operators with no local representatives in Japan may wish to consider discussing with their Japanese outside counsel about retaining such counsel himself/herself as a representative in Japan for this purpose.[6]

Please note that most of the new qualification requirements will 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.

6. Revised Form 20 Requires Additional Information

According to the Draft Amendments, Form 20 will be revised to require the following information:

- Names, addresses and phone numbers of offices at which the Exempted Operator conducts marketing activities and investment management activities in reliance on the Exemption.

- Name, address and phone number of the representative in Japan (see Section 5 above),
- The Exempted Operator's website address.
- Fund types and details of proposed investments.[7]
- Names and types of all QIIs that make investments in the LPS.
- Certain other additional information.

Existing Exempted Operators will also be required to file a supplemental notification covering these matters within a grace period of six months.

7. Greater Number of Attachments to Form 20 Notification

Currently, in the case of foreign Exempted Operators, a Form 20 Notification need only be accompanied by a simple affidavit. The New Act will require, in addition, submitting various documents, including the following:

- A letter stating that the Exempted Operator meets the qualification requirements.
- The Exempted Operator's articles of incorporation and, in some cases, the relevant limited partnership agreement(s).
- CVs, affidavits (in the case of non-residents) and declarations of the directors and officers, as well as certain key employees, of the Exempted Operator.

Existing Exempted Operators will likewise be required to submit similar documents within a grace period of six months.

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

While the current FIEA imposes only a few conduct requirements on Exempted Operators, the New Act will 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 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*) will be exempt from the first four items listed above. (Note, however, each such other "Professional Investor" (except for the Japanese government and the Bank of Japan) can opt not to be treated as a "Professional Investor" and that an Exempted Operator must notify them that they have such option.)

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

9. 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 new regulations are implemented, the FSA will 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 information may be added to the list on the FSA's website.

Further, Exempted Operators will be required to make available to the public a part of the content of their Form 20 Notifications at their relevant offices in Japan or on their own websites[8] without delay after the relevant filings. This will also apply to existing Exempted Operators and there will be no grace period to comply with this new requirement.

According to the Draft Amendments, almost all of the content of the Form 20 Notifications will be subject to the new disclosure requirements, except information relating to the privacy of employees or investors.

10. New Reporting/Record-Keeping Requirements

The New Act also introduces new ongoing reporting and record-keeping requirements for Exempted Operators, which are quite similar to those applicable to Type II FIBOs and IMBOs. Exempted Operators will 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.

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 in Japan or on their websites[9].

The requirement to prepare and maintain records will also apply to existing Exempted Operators with no grace period. The requirement regarding annual business reports will apply with respect to each Exempted Operator's business year commencing on or after the New Act's entry into force.

11. Extended Enforcement Powers

The New Act strengthens 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 to abolish their business operations. The regulators will 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 conduct on-site inspections of their or their delegates' relevant offices. The New Act also facilitates petitioning by the regulators to a court for an injunction against harmful marketing activities.

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

12. Roadmap for Existing Exempted Operators

The regulations introduced by the New Act will 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 new regulations are implemented.[10] Foreign Exempted Operators who decide to continue to rely on the Exemption should at least take the following steps to comply with the new regulations:

(*i*) Before the New Act's entry into force

- Check (*a*) whether target investors are categorized as QIIs or non-QIIs and (*b*) if the latter, whether they are Professional Investors and whether they are covered by the Exemption (see Section 3).
- Consider limiting the scope of target investors to Professional Investors in order to be exempt from some of the burdensome conduct requirements (see Section 8).
- Confirm that the Exempted Operator meets the stricter qualification requirements (see Section 5).
- Prepare to appoint a representative in Japan within the grace period of six months (see Section 5).
- Check whether the business operations meet the new conduct requirements (see Section 8) and take necessary actions to ensure compliance therewith no later than the New Act's entry into force.
- Prepare templates for records required under the new record-keeping requirements (see Section 10) so that the Exempted Operator can prepare and maintain necessary records after the New Act's entry into force.
- Obtain more detailed information on the New Act and the finalized draft amendments to the relevant cabinet order and cabinet ordinance in order to fully comply with the new regulations, including those related to the narrowing of the scope of funds that may rely on the Exemption as mentioned in Section 4 above.

(*ii*) After the New Act's entry into force

- Appoint a representative in Japan within a grace period of six months (see Section 5).
- Prepare and file a supplementary notification and new attachments with the KLFB (see Sections 6 and 7).
- Limit the scope of target investors in compliance with the new requirements (see Sections 3, 4 and 8).
- Prepare and maintain records required under the new record-keeping requirements (see Section 10).
- Prepare and file an annual business report with the KLFB within 3 months of the end of the business year commencing on or after the New Act's entry into force, and thereafter on an annual basis (see Section 10).
- Establish procedures to meet the disclosure and reporting requirements (see Sections 9 and 10).

Given that ensuring compliance with these various new requirements may take substantial time, you may wish to consider contacting us sometime soon if you need our assistance. We would also be happy to assist existing operators who are considering ceasing to rely on the Exemption so that they can avoid the new requirements. In that case, we recommend that the Exempted Operator file an abolishment notification before the New Act's entry into force and, accordingly, that it contact us at its earliest convenience.

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1 http://www.jurists.co.jp/en/topics/newsletter_17758.html

2 Certain similar collective investment schemes will also be covered by this item.

3 After the amendments, GPs that accept non-QIIs outside the scope of the Exemption 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.

4 Although the Draft Amendments state the monetary threshold in terms of "contributed capital minus loans", we believe this does not make sense and that such term should be understood as "assets (under management) minus loans." Indeed, we have submitted a comment to the FSA to address this point.

5 Although a list of such investors is provided in the Draft Amendments, the exact scope is still unclear due to the structure of the relevant provisions. We have therefore submitted a comment to the FSA with a view to clarifying this point.

6 Further, the New Act introduces a new requirement related to international cooperation and information exchange among financial supervisors and regulators, under which foreign Exempted Operators 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, will be excluded from the Exemption. Considering, however, that almost all of the jurisdictions commonly selected by foreign Exempted Operators (such as the Cayman Islands) have signed the MMoU, this new requirement is not expected to have a material impact on most of such Exempted Operators.

7 In the public comment procedures, we have asked the FSA to provide further clarification as to the extent to which the details of investments are required to be included in the Form 20 notification.

8 We have submitted a comment to the FSA with a view to clarifying whether this disclosure obligation is completely inapplicable to Exempted Operators with no Japanese offices or whether they must make the disclosure on their websites.

9 See note 8 above. We submitted a similar comment with respect to the disclosure obligation regarding annual business reports.

10 For example, if a foreign investment management firm intends only to conduct marketing activities aimed at certain Japanese financial institutions and only from outside Japan, via e-mail, telephone, video conference or other remote communication tool, 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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