Japan

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RETAIL FUNDS

1. Please give a brief overview of the retail funds market in your jurisdiction. (How developed is the market? Has it been active in the past year?)

Open-ended retail funds

Japanese rules and regulations for funds do not vary according to whether funds are open-ended or closed-ended, but according to factors such as:

- The type of fund vehicle.
- The object of investment.
- The method of inviting investment.
- Whether interests in the fund are listed.

Japanese funds that are generally considered to be open-ended retail funds are structured as open-type investment trusts governed by the Law Concerning Investment Trusts and Investment Companies in Japan (LITIC). These trusts mainly invest in securities (Securities Investment Trusts). Investment trusts are managed by investment trust management companies (ITM Companies) that are registered under the Financial Instruments and Exchange Law of Japan (FIEL).

The 1980s saw an enormous increase (from about JPY6 trillion (about US$64.8 billion) to about JPY59 trillion (about US$637.2 billion)) in the aggregate net asset value (NAV) of publicly offered investment trusts. The investment trusts market is now facing additional growth due to a number of factors which took place in the early 2000s:

- The relaxation of regulations regarding investment management business.
- The diversification of financial investments.
- The expansion of distribution channels.
- An improvement in market conditions.

In December 2009 there existed 3,600 publicly offered investment trusts with an aggregate NAV of JPY61 trillion (about US$658.8 billion) (survey conducted by the Investment Trusts Association, Japan (ITAJ)).

Closed-ended retail funds

The funds in Japan that are generally considered to be closed-ended retail funds are structured as:

- Exchange-traded funds (ETFs). ETFs consist principally of funds whose interests are listed on markets and who have a value linked to an objective index. Domestic ETFs that are currently in existence are structured as investment trusts under the LITIC and managed by ITM Companies.

Many ETFs now have in-kind contributions and in-kind redemptions, since this was first permitted in 2001. The conditions for this have now been relaxed:

- the tracked indexes now need not be specifically designated by the Commissioner of the Financial Services Agency (FSA);
- the investment objects can include not only securities but also commodities and commodities-related rights.

In December 2009 there existed about 72 Japanese ETFs with an aggregate NAV of about JPY2.3 trillion (about US$24.8 billion) (survey conducted by the ITAJ).

- Japanese real estate investment trusts (J-REITs). These consist principally of investment companies (that is, a corporate entity despite being generally called a “trust”) governed by the LITIC whose interests are listed on stock exchanges (Exchanges) and who mainly invest in real estate and real estate-related rights. They have been permitted since 2000.

In December 2009 there existed about 42 J-REITs that together had an aggregate NAV of about JPY4,020 billion (about US$43.4 billion). In 2001 there existed only 2 J-REITs with an aggregate NAV of about JPY240 billion (about US$2.6 billion) (survey conducted by the ITAJ).

2. What are the key statutes, regulations and rules that govern retail funds in your jurisdiction? What regulatory bodies are involved in regulating retail funds?

Open-ended retail funds

The key statutes are the LITIC and the FIEL (see Question 1, Open-ended retail funds). The key regulations and rules are the rules made under those statutes and the various rules imposed by the ITAJ on its members.

The regulatory bodies involved in regulating the funds are:

- The FSA, as overall regulatory authority.
- Each local financial bureau, to which certain authorities are delegated by the FSA.
- The Securities and Exchange Surveillance Commission (SESC), set up under the FSA to:
  - conduct inspections and research on investment funds; and
  - recommend sanctions to the Commissioner of the FSA, if necessary.
Country Q&A  Japan  Investment Funds 2010

Closed-ended retail funds
The same statutes, regulations and regulatory authorities that apply to investment funds apply to ETFs and J-REITs (see above, Open-ended retail funds).

In addition, J-REITs often trade in real estate. In relation to that trading, the Building Lots and Buildings Transaction Business Act (BLBTA) and the regulations and rules made under that statute are the key statutes, regulations and rules.

Finally, ETFs and J-REITs must comply with the listing rules of each relevant Exchange.

3. Do the retail funds themselves have to be authorised or licensed? If so, what are the main steps involved?

Open-ended retail funds
Since 1996 Japan has experienced a trend towards relaxation of regulations and the promotion of free and fair competition. As a result, since 1998 ITM Companies managing investment trusts have only been required to file prior notification with the FSA, rather than being granted an approval, under the LITIC.

While it is not an authorisation or licensing process, to publicly offer investment trusts ITM Companies must also file a securities registration statement (SRS) (FIEL). An SRS is a public disclosure document, and a company making a material misstatement in the SRS and other parties contributing to it can incur liability for that misstatement.

Closed-ended retail funds
The prior notification and disclosure rules that apply to investment trusts also apply to ETFs (see above, Open-ended retail funds).

An investment company that constitutes a J-REIT must:

- File an advance notification with the relevant financial bureau.
- Be registered with the relevant financial bureau.

Asset management activities can only be conducted by an asset management company registered to conduct investment management business under the FIEL, with which the investment company must enter into an asset management agreement. They cannot be conducted by the J-REIT itself. In addition, the investment company must file an SRS (see above, Open-ended retail funds).

Finally, both ETFs and J-REITs must comply with the listing approval process of the relevant Exchange.

4. Who can market retail funds?

Open-ended retail funds
Institutions that can market open-ended retail funds include:

- Firms registered to conduct “type I financial instruments business” as defined in the FIEL (Type I Financial Instruments Firms). These are basically securities companies.

- “Registered financial institutions” as defined in the FIEL (banks, insurance companies, co-operative financial institutions, Japan Post Bank through local post offices, and so on).

In addition, ITM Companies as issuers can offer interests in open-ended funds by themselves if they are registered under the FIEL to conduct “type II financial instruments business” (Type II Financial Instruments Firms).

Types I and II Financial Instruments Firms and other firms registered under the FIEL to conduct financial instruments business are collectively referred to as Financial Instruments Firms.

Closed-ended retail funds
The same rules that apply to investment trusts apply to ETFs (see above, Open-ended retail funds).

Those firms who can market open-ended retail funds can also market interests in a J-REIT. However, officers of the investment company (that is, the J-REIT itself), cannot offer interests in the J-REIT, although the J-REIT’s asset management company, if a Type II Financial Instrument Firm, can offer interests.

5. To whom can retail funds be marketed?

Open-ended retail funds
Generally, investment funds can be marketed to anyone. However, the FIEL provides that funds cannot be marketed to investors in a way that is inappropriate in light of the investors’ knowledge, experience, financial condition or purpose for concluding a contract for a financial instruments transaction, and therefore would result in or be likely to result in the insufficient protection of investors.

Violation of these “suitability principles” can lead to:

- Administrative sanctions.
- Civil damages in accordance with case law.
- In theory, the nullification of contracts.

Closed-ended retail funds
See above, Open-ended retail funds.

6. What are the key requirements that apply to managers/operators of retail funds?

Open-ended retail funds
To establish and manage investment trusts, ITM Companies must be registered under the FIEL as Financial Instruments Firms engaging in investment management business. An application for registration may be rejected, among other cases, if the applicant is considered unable to properly conduct its business because of its:

- Lack of sufficiently knowledgeable and experienced personnel.
- Organisation.

The standard for investment management business is particularly high.
Closed-ended retail funds
The rules relating to ITM Companies also apply to ETFs, and to the managers of J-REITs (see above, Open-ended retail funds).

If the J-REIT’s assets include real estate, the asset management company must have a real estate business licence under the BLBTA. In addition, if the J-REIT intends to invest mainly in real estate, the asset management company must have approval as a discretionary trading agent under the BLBTA.

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds
The trustee of an investment trust holds the portfolio of assets on behalf of the trust. Those assets must be held independently and segregated from the other assets of the trustee and the assets of other trusts (LITIC and the Trust Act).

Closed-ended retail funds
The rules which apply to investment trusts also apply to ETFs (see above, Open-ended retail funds).

In relation to J-REITs, the investment company holds the portfolio of assets (LITIC). The investment company cannot conduct any business other than managing the portfolio of assets. Asset management, custody of assets and general administrative services must be outsourced to a third party asset management company, a custodian and an administrator, respectively.

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures? What are the participants’ interests in the fund called (for example, share or unit)?

Open-ended retail funds
Open-ended retail funds are mainly structured as investment trusts under the LITIC (see Question 1, Open-ended retail funds). The fact that an investment trust is managed by an ITM Company, which is registered under the FIEL to conduct investment management business, gives a certain level of comfort to investors from the regulatory viewpoint. ITM Companies are mostly well established and capable of conducting NAV calculations and subscription/redemption procedures. There exists no other structure for open-ended retail funds that invest in securities.

Interests in investment trusts are called “beneficiary certificates”. Currently, however, a book-entry system is used for all investment trusts offered publicly in Japan, and the beneficiary rights in those investment trusts that are held by investors are not certificated.

Closed-ended retail funds
Closed-ended retail funds are typically either ETFs under the LITIC, or J-REITs structured as investment companies under the LITIC (see Question 1, Closed-ended retail funds).

For ETFs formed domestically, the only structures used are investment trusts. The capability of ITM Companies to organise and manage investment trusts has helped the development of ETFs in Japan. A “beneficiary certificate issuing trust”, which was created in 2007 by an amendment to the Trust Act, could be used for a “spot commodity ETF”, aiming to track the price movements of a specific kind of commodity and whose assets are mainly comprised of that commodity. However, no ETF with that structure currently exists.

For J-REITs, investment companies, rather than investment trusts, are generally used. Investment trusts could be used for real estate investments. However, because of the difference in liquidity and the manner of trading real estate assets, it appears that the NAV calculation and subscription/redemption mechanism would be quite different from the calculation and mechanisms for funds investing in securities. ITM Companies specialising in Securities Investment Trusts do not generally operate J-REITs.

9. Describe the investment and borrowing restrictions to which retail funds are subject.

Open-ended retail funds
The main investment restrictions that apply to investments are:

- An investment trust cannot invest in assets other than “specified assets”, such as:
  - securities;
  - rights related to derivative transactions;
  - real estate; and
  - commodities and rights related to certain commodity derivative transactions.

- A Securities Investment Trust must invest more than 50% of its investment trust assets in securities (excluding certain rights, such as partnership interests), including derivative transactions related to those securities.

- An ITM Company cannot invest, on behalf of one or more investment trusts, in more than 50% (in aggregate) of the voting rights issued by one company.

- An ITM Company of a publicly offered investment trust cannot instruct the investment trust to conduct derivative transactions through which the amount at risk, calculated in a reasonable manner, will exceed the NAV of the investment trust.

Other investment restrictions to which investment trusts are subject are set out in the ITAJ and include:

- Publicly offered investment trusts cannot invest in shares other than shares that are:
  - listed on a financial instruments exchange or foreign financial instruments market;
  - registered for over the counter (OTC) trading; or
  - disclosed as required by the FIEL or the Companies Act, or similarly disclosed, and satisfying the ITAJ’s further requirements.

- Publicly offered investment trusts cannot invest in securitised products unless this investment can be made at market value.

Japanese law does not set out any borrowing restrictions for investment trusts. However, ITAJ rules provide that an ITM Company managing investment trusts cannot borrow money on behalf of the trusts except where necessary to:

- Pay redemption proceeds to the redeeming beneficiaries.
Country Q&A Japan

10. Can the manager/operator place any restrictions on the issue and redemption of interests in retail funds?

Open-ended retail funds

An ITM Company of an investment trust can place any restriction on subscriptions and redemptions under the trust deed. Normally, however, those restrictions are limited to:

- Restrictions imposed as a result of extraordinary events (such as market disruption).
- Providing an initial closed period for redemption.
- Depending on the type of investment, restricting subscriptions and redemptions to once per month, for example, rather than permitting them on a daily basis.

Closed-ended retail funds

Interests in an ETF and J-REIT are traded on a market. An Exchange’s listing criteria generally provide that ETF and J-REIT interests cannot be redeemed (except, in the case of an ETF, exchanges for in-kind portfolio assets in a certain unit size).

11. Describe any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties.

Open-ended retail funds

A book-entry system is used for all investment trusts offered publicly in Japan. Transfers of interests in an investment trust are not effective and complete unless (Law Concerning Book-Entry Transfer of Corporate Bonds, Stocks, Etc. of Japan):

- The transferor applies for a book-entry transfer with the relevant book-entry transfer institution.
- The transferee receives a record of registration of the related increase in units.

Closed-ended retail funds

As interests in ETFs and J-REITs are traded on an Exchange, they are not subject to any transfer restrictions.

12. Describe the periodic reporting requirements to:

- Investors.
- Regulators.

Open-ended retail funds

- Investors. The disclosure system has played a central role in investor protection. It is regulated by the FIEL, which is complemented by the LITIC and regulations imposed by the ITAJ.

Periodic reporting is required for publicly offered investment funds as follows:

- **A management report under the LITIC.** A management report must be delivered to known investors without delay (normally, within some weeks), after the end of each calculation period of the trust (or, if that period is less than six months, every six months). A management report must include:
  - a balance sheet and a profit and loss account;
  - allocation and list of portfolio securities;
  - principal transactions during the period;
  - descriptions of costs incurred per unit during the period; and
  - certain other financial and performance information.

- **Timely disclosure under regulations imposed by the ITAJ.** In general, an outline of an investment trust, together with certain financial information, must be disclosed on a monthly basis on the ITM Company’s website.

- **Regulators.** The ITM Company must file the following:

  - **Securities report.** The ITM Company must file a securities report through an electronic disclosure system called the Electronic Disclosure for Investors’ NETwork (EDINET) within three months after the end of each calculation period of the trust (or, if that period is less than six months, every six months). The securities report must include comprehensive information regarding the fund and the ITM Company, including two years’ audited financial statements for each.

  - **Semi-annual report.** For an investment trust whose accounting period exceeds six months, a semi-annual report must be filed through EDINET within three months after the expiry of the first six months of the accounting period. Audited financial statements are required for the two most recent first halves of the fiscal years of the fund and the ITM Company.

  - **Management report under the LITIC.** The management report must be submitted to the FSA without delay after being prepared (see above, Investors).
Closed-ended retail funds

- Investors. For listed ETFs, neither a management report nor timely disclosure under the ITAJ regulations is required (see above, Open-ended retail funds: Investors).

  For J-REITs, the following documents must be delivered to the shareholders (LITIC):
  - financial reports (balance sheet, profit and loss account, and so on);
  - an asset management report;
  - a report concerning money distribution; and
  - an audit report.

- Regulators. For ETFs, the following documents must be submitted:
  - a securities report;
  - a semi-annual report;
  - a daily report under each relevant Exchange's listing rules; and
  - a settlement report/midterm settlement report under each relevant Exchange's listing rules.

For J-REITs, the following documents must be submitted:
  - a securities report;
  - a semi-annual report, where the calculation period exceeds six months (as J-REITs generally have six-month calculation periods, in practice most do not submit this report);
  - a report concerning the asset management system and so on under each relevant Exchange's listing rules, within three months after the end of each fiscal year;
  - a settlement report or midterm settlement report under each relevant Exchange's listing rules (a midterm settlement report is required where the calculation period exceeds six months and therefore is generally not necessary).

13. Describe the tax treatment for:

- Funds.
- Resident investors.
- Non-resident investors.

Open-ended retail funds

- Funds. Securities Investment Trusts are not subject to tax at the fund level. The investors are not taxed until distributions or redemptions are made to them.

- Resident investors. Individual investors in publicly offered open-ended investment trusts are generally taxed in the same manner as for listed shares. Distributions are currently subject to withholding tax at a reduced rate of 10% (income tax of 7% and local tax of 3%) until 31 December 2011, after which the rate of 20% (income tax of 15% and local tax of 5%) will apply. Individual investors can elect whether to file a tax return. If they do, the distributions are subject to taxation on aggregate income as dividend income. If they elect not to file a tax return, the tax procedure finishes with the withholding.

  For profits on redemption, which are treated as capital gains, individual investors are generally subject to separate self-assessment taxation at the same rate as taxation on income. Individual investors can set off capital gains and losses on the sale of such an investment trust against capital gains and losses derived from certain other public securities, such as:
  - listed shares, ETFs and J-REITs; and
  - other publicly offered investment trusts (other than bond investment trusts (see below)).

  However, individual investors in “bond investment trusts”, which do not invest in any equity securities, are taxed differently. Distributions and profits on redemption are treated as interest income and subject to withholding tax at a rate of 20% (income tax of 15% and local tax of 5%), separately from other income.

- Non-resident investors. Non-resident investors are taxed (subject to any applicable tax treaties) solely on income derived from domestic sources in Japan. Individual non-resident investors with no permanent establishment in Japan are not subject to tax in relation to any distributions or capital gains (including profits on redemption).

Closed-ended retail funds

- Funds. ETFs are taxed in the same way as publicly offered open-ended investment trusts (see above, Open-ended retail funds: Funds).

  J-REITs, which are investment companies, must satisfy certain requirements to not be subject to tax at the fund level (that is, to avoid double taxation), including that:
  - at least 90% of the distributable income for the fiscal year must be distributed;
  - no single shareholder, considered together with certain related parties, holds more than 50% of the total outstanding shares as of the fiscal year-end.

- Resident investors. Individual investors in listed closed-ended retail funds, such as ETFs and J-REITs, are generally taxed in the same manner as for listed shares. Therefore, the same tax treatment applies as for open-ended retail funds (see above, Open-ended retail funds: Resident investors).

- Non-resident investors. See above, Open-ended retail funds: Non-resident investors.


Regulations related to fund formation and investment in retail funds have been relaxed in recent years, to promote individual investment (see Question 1, Open-ended retail funds). The form of prospectus for publicly offered investment trusts will be simplified to be user friendly, according to the amended rules under the FIEL (to be effective 1 April 2010).

HEDGE FUNDS

15. Please give a brief overview of the hedge funds market in your jurisdiction. (How developed is the market? Has it been active in the past year?)

The term “hedge fund” has not been formally defined in Japanese regulations, nor does it have a precise meaning in Japanese
industry terminology. However, hedge funds are generally understood in Japan as being funds with attributes including:

- Adopting alternative strategies.
- Using leverage.
- Having high exposure to risks.
- Charging a performance fee.

Over the past four to five years various reports on the market status and regulation of hedge funds have been published. These have demonstrated a rapid rise in the importance of the hedge fund market. Two examples are provided below.

**The FSA’s 2005/6 surveys**

The FSA analysed hedge funds (characterised by reference to their leverage, incentive fees, and investment strategies) by conducting hearings with financial institutions under its supervision. It came to three main findings:

- During the period 2000 to 2004 about JPY2.5 trillion (about US$27 billion) in capital was raised for 573 funds by 57 companies. From 2002 to 2003 the number of funds set up in each year and their aggregate capital amount were doubled. During the period 2000 to 2004, 60% of hedge funds (by capital raised) were governed by Japanese law, 25% by Cayman law and 9% by Irish law.
- From 2000 to 2005, the aggregate amount distributed in relation to interests in hedge funds by 101 companies was about JPY2.77 trillion (about US$29.9 billion) by the end of 2006.
- In early 2006, the aggregate monetary amount for interests in hedge funds was about JPY7.44 trillion (about US$79.9 billion), of which more than 60% is on a Yen basis, just under 40% is on a US dollars basis (and a very small rate is on other basis), and of which:
  - insurance companies held 26%;
  - major banks held 24%;
  - local banks held 15%; and
  - trust banks held 15%.

**Pension Fund Association of Japan’s survey**

This survey found that the aggregate monetary amount for interests in hedge funds held by pension funds increased rapidly from 2002 to about JPY2.77 trillion (about US$29.9 billion) by the end of 2006.

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? What regulatory bodies are involved in regulating hedge funds?

Hedge funds are not defined under legislation (see Question 15). There are therefore no statutes or regulations specifically concerning hedge funds. Whether statutes and regulations that concern funds cover hedge funds depends on the vehicle used for investment and the investment objective.

As well as trusts and companies, collective investment schemes (CISs) are used as vehicles for hedge funds. A CIS, in this chapter, is used to refer to the various forms of partnership that can be used for hedge funds (this terminology itself is not used in the FIEL but is generally used to mean a certain category of rights that are deemed “securities” under the FIEL). These include:

- A partnership formed by a partnership agreement under the Civil Code (ninni-kumiai) (NK).
- An investment limited partnership (Investment LPS) formed by a limited partnership agreement for investment under the Limited Partnership Act for Investment (LPAI).
- A profit sharing agreement known as an “anonymous partnership” (tokumei kumiai) agreement (TK agreement) formed under the Commercial Code.
- A foreign limited partnership.

See Question 23.

Hedge funds are considered to primarily invest in securities or rights related to derivatives. The key statutes are therefore the FIEL (and the LITIC for hedge funds that are investment trusts).

The regulatory bodies are the FSA, the relevant financial bureau and the SESC (see Question 2, Open-ended retail funds).

Other statutes may apply to funds that invest in assets other than securities or rights related to derivatives, for example:

- Hedge funds investing in commodities may be subject to the Act for Regulation of Business Concerning Commodities Investment, in addition to other more general rules and regulations.
- Hedge funds that invest in real estate through “designated real estate joint enterprise contracts” are subject to the Act Concerning Designated Real Estate Joint Enterprises.

However, it may be inappropriate to consider such funds as hedge funds (see above).

17. How are the following areas regulated (if at all) in relation to hedge funds:

- Risk.
- Valuation and pricing.
- Systems and controls.
- Insider dealing and market abuse.
- Transparency.
- Money laundering.
- Short selling.

Hedge funds are not statutorily defined or specifically regulated (see Question 16). However, a hedge fund can be subject to general rules, such as regulations concerning unfair trade practices or transfer of crime proceeds. Even where no specific regulation applies, the FSA may impose administrative sanctions if it discovers problems with the appropriateness of a hedge fund’s business or system of administration where the hedge fund manager is a Financial Instruments Firm. In addition, activities that may not be conducted without registration may lead to a criminal penalty.
Risk. There are no specific regulations.

Valuation and pricing. There are no specific regulations.

Systems and controls. There are no specific regulations.

Insider dealing and market abuse. The FIEL includes regulations regarding market abuse. These are applicable to investment funds, including hedge funds, and cover the following:

- prohibited acts of corporate insiders;
- prohibition of market manipulation;
- prohibition of spreading rumours, using fraudulent means, committing assault or intimidation; and
- short-swing profit.

In relation to short-swing profit, where a holder of 10% or more of a listed company’s voting rights has traded in shares or certain other securities of the same issuer, the holder must submit a report by the 15th day of the month following the trade. Further, if that holder receives proceeds from conducting buying and selling trades within six months, the holder may be required to disgorge the profit and return it to the issuing company (FIEL).

Transparency. There are no specific regulations.


- conduct customer identification;
- prepare customer identification records; and
- report suspicious transactions to a competent administrative agency.

Business operators include Financial Instruments Firms and operators that qualify for the QII Exemption acting as investment managers of hedge funds (see Questions 6 and 18).

Any person can be subject to imprisonment for:

- disguising facts in relation to the acquisition or disposition of criminal proceeds;
- concealing criminal proceeds; or
- intentionally receiving criminal proceeds.

In addition, criminal proceeds or proceeds related to crime may be seized under the Act for Punishment of Organised Crimes, Control of Crime Proceeds and Other Matters.

Short selling. Short selling is subject to the following rules in relation to listed shares in Japan:

- an “uptick rule”, which prohibits, in principle, short selling at prices no higher than the latest market price;
- requirements for traders to verify and flag whether or not the transactions in question are short selling; and
- exchanges are required to make daily announcements on their aggregate price of short selling regarding all securities and aggregate price of short selling by sector.

In addition, the following restrictions are in place, which were introduced as temporary measures following the financial crisis in late 2008 and have been kept in force since then:

- naked short selling (short selling where no method for obtaining the relevant shares, such as borrowing of shares, is provided at the time of selling) is prohibited; and
- holders of a short position of a certain level (in principle, 0.25% or more of the outstanding issued shares) are required to report to exchanges through securities firms. Exchanges are required to publicly disclose this information.

18. Who can market hedge funds?

In relation to hedge funds that are formed as investment trusts, see Question 4, Open-ended retail funds.

Where the hedge fund vehicle is a CIS, interests can be marketed by Type II Financial Instruments Firms (including marketing by the issuers themselves) (see Question 4, Open-ended retail funds).

The following are generally required to register under the FIEL to conduct investment management business:

- A person offering interests in a CIS.
- A person (such as a general partner (GP)) managing investors’ assets in securities or derivative transactions by acting as operator of a CIS.

However, the FIEL provides for an exemption (QII Exemption) from the registration requirement where both of the following apply:

- At least one qualified institutional investor (QII) holds interests in the fund. QIIs can include banks, insurance companies, and certain types of institutional investors, who are automatically QIIs, and certain other types of investors, including natural persons, satisfying certain requirements, who can be QIIs by making a filing.
- The number of holders who are not QIIs must be under 50.

A restriction on transfer of interests must also be in place, which restricts a non-QII investor from transferring its interests unless transferring all of its interests at one time, and a QII investor is restricted from transferring its interests to anyone other than a QII.

To take advantage of this exemption, the GP must file a notification in advance with the relevant financial bureau.

19. To whom can hedge funds be marketed?

See Question 5, Open-ended retail funds. However, the suitability principles will rarely apply, as most investors in hedge funds are institutional investors with substantial knowledge of these types of investment.

20. Who holds the portfolio of assets? What regulations are in place for its protection?

Where the hedge fund vehicle is an investment trust or investment company under the LITIC, the same rules apply as for retail funds (see Question 7).

Where the hedge fund vehicle is a CIS, the entity holding the portfolio of assets depends on the governing laws under which the vehicle is set up. For example, for a partnership (either an NK or Investment LPS), the presumption is that each general partner and each limited partner together have joint ownership of the portfolio. In contrast, for a TK, the TK operator holds the portfolio.
21. Describe the key disclosure or filing requirements (if any) that must be done by the fund (for example, in relation to the prospectus or offering memorandum and side letters).

Where the hedge fund vehicle is an investment trust, the ITM Company of the investment trust must file a notification with the relevant financial bureau before concluding, amending or cancelling an investment trust agreement.

Where the hedge fund vehicle is an Investment LPS under the LPAI, the fund is registered under the Investment LPS Registration Rules.

Otherwise disclosure documents are usually not required for hedge funds, as the fund is generally offered through a private placement for QIIs (see Question 18).

22. What are the key requirements that apply to managers/operators of hedge funds?

The type of business which managers/operators of hedge funds conduct falls within “investment management business” as defined in the FIEL. Therefore, those managers/operators must generally be registered as Financial Instruments Firms engaging in investment management business (see Question 18).

However, where the manager/operator is a GP of a CIS, the QII Exemption may be available (see Question 18).

In addition, an exemption from the registration requirement is available for a foreign CIS where the following requirements are satisfied:

- The Japan-resident investors of the CIS do not exceed nine in number and each is either:
  - a QII; or
  - a person who is conducting investment management business in relation to which that person has filed a notification based on the QII Exemption.
- The amount of contributions made by those investors is no greater than one-third of the total amount of contributions to the CIS.

Additional requirements apply when a Japan-resident investor is itself a CIS. In that case, each investor in that CIS must:

- Be a QII.
- Be counted as a Japan-resident investor for the purposes of the maximum of nine Japan-resident investors, in place of the Japan-resident investor that is itself a CIS.

Where the exemption applies, investment management by the managers/operators falls outside investment management business under the FIEL. Therefore, the managers/operators need not be registered as Financial Instruments Firms or file notification of the QII Exemption. This exemption applies only to the GP’s investment management and does not apply to its offering of the CIS interests.

23. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures? What are the participants’ interests in the fund called (for example, share or unit)?

When considering whether to use a particular structure, the key factors include:

- Limitation of the investors’ liability.
- Avoidance of double taxation.
- Investment objectives or strategies.
- Regulatory requirements.
- Taxation of in-kind distributions.

The main legal vehicles used to set up hedge funds are:

- Trusts, including investment trusts. Investment trusts have the disadvantages of restrictions on investment objects and strategies and regulatory requirements (see Questions 3 to 12). They have the advantage of clear rights for investors over portfolio assets (see Question 7, Open-ended retail funds).
- Companies.
- CISs (see Question 16). These include:
  - an NK. This has the disadvantage of all partners having unlimited liability;
  - an Investment LPS. This is a popular vehicle for private equity funds and buyout funds and can be used for hedge funds as well, although it may not be suitable for that purpose (see Question 24, Onshore);
  - a TK. This has certain tax disadvantages including:
    - the unavailability of the “dividends-received exclusion from gross revenue” (which would allow a corporate investor in a Japanese company to deduct dividends received from that company and therefore allow avoidance of double taxation, but is not available to a corporate TK investor as the dividends are recharacterised if paid through a TK); and
    - taxation of in-kind distribution.

However, there is no need for fund registration or audit of the financial statements as would be required for an Investment LPS;
- a foreign limited partnership (see Question 24, Offshore).

The participant’s interests in investment trusts are called beneficiary certificates or, if no certificates are issued, beneficiary certificates or, if no certificates are issued, beneficiary rights. For other funds, the interests are called shares or interests.

24. What are the advantages and disadvantages of using onshore and offshore structures?

Onshore

If the fund is organised by a Japanese manager and the investors are limited to Japanese institutional investors, onshore structures are quite straightforward in terms of:
In addition, no translation cost is involved. However, the Investment LPS, which is typically used for private equity funds, is not suitable for hedge funds unless investing in a business (either through equity or debt financing or acquisition of securities) or certain kinds of business-related property such as intellectual property. If an Investment LPS or any other kind of CIS (which can rely on the QII Exemption) is not used, the manager of a hedge fund in Japan must normally be required to be registered to conduct investment management business.

Offshore

In establishing a hedge fund using an offshore structure, a non-Japanese investment manager is generally not required to register under the FIEL to conduct its business. A general partner of an offshore CIS (including a limited partnership) could be subject to a registration requirement, but can be exempted in most cases under the QII Exemption. Therefore, offshore structures are generally used:

- Where a non-Japanese investment manager is involved.
- Where there are foreign investors.

25. Describe the tax treatment for:

- Funds.
- Resident investors.
- Non-resident investors.

Funds. Partnerships are generally tax transparent. Hedge funds structured as a Securities Investment Trust (which is domestically formed) or foreign investment trust are generally not subject to Japanese tax at the fund level. Hedge funds structured as companies are generally taxed at the fund level. Offshore funds structured as trusts (other than trusts equivalent to a Securities Investment Trust or companies could be subject to the controlled foreign company (CFC) rules or tax haven taxation.

Resident investors. For tax purposes, investors in a partnership are generally regarded as directly holding the fund’s portfolio. Investors in a privately placed investment trust or in non-listed companies are generally subject to 20% withholding tax on distributions or dividends, and a tax return must be filed. Those investors’ capital gains are generally subject to separate self-assessment taxation at a rate of 20%.

Non-resident investors. Non-resident investors are taxed (subject to any applicable tax treaties) solely on income derived from domestic sources in Japan. Individual non-resident investors with no permanent establishment in Japan are generally not subject to tax in relation to any distributions or capital gains (including profits on redemption). However, under certain circumstances a capital gain may be subject to Japanese tax. This includes where an investor, together with its related parties, has held 25% or more of the total outstanding shares of a Japanese company at any time within the three years prior to the end of the tax year and sells 5% or more within the tax year. This capital gain tax on the investor applies whether the sale of shares is made directly by that investor or indirectly through a partnership. Where the sale is made through a partnership, these percentages are generally counted on the basis of that partnership’s transaction, no matter how small the investor’s interest is in that partnership. (By satisfying certain requirements, a passive investor in the partnership can be exempted from this taxation.)

26. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

There are no applicable regulations restricting redemptions. However, the hedge fund’s founding agreement can set out restrictions.

Where investment in an investment trust’s interests is solicited by a private placement, applicable transfer restrictions depend on the type of the private placement.

Where the GP of a partnership uses the QII Exemption, certain transfer restrictions will apply (see Question 18).

27. Please summarise any proposals for the reform of hedge fund regulation in your jurisdiction.

There has been considerable global consensus concerning the desirability, for the purpose of financial stabilisation, of introducing a registry system for hedge funds and their investment managers and appropriate disclosure regulations for evaluating systemic risk.

In this connection, the FSA has published a report called “Outline Regarding Development of Institutions Related to Financial and Capital Markets”, which concludes that:

- Managers/operators of foreign investment trusts that are set up or managed directly from Japan and for which Japanese investors are sought should be newly subject to a registry system.
- There should be an enhancement of reporting obligations, including a requirement for managers/operators of hedge funds to continuously report risk management conditions and so on of the portfolio of assets, in combination with other countries.

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