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COMMENTARY

Tightened Regulations on Managers of Funds Marketed to Japanese Investors Will Come into Force Shortly

The 2015 amendments (the "Amendments") to the Financial Instruments and Exchange Act of Japan (the "FIEA," and the FIEA amended by the Amendments, the "Amended FIEA"), which will impose far-tighter regulations on managers of funds marketed to Japanese investors, will come into force as of March 1, 2016. This *Commentary* outlines key futures of these new regulations under the Amended FIEA, together with their backgrounds.

Background

Before going into details of the Amendments, we set forth below the current regulations applicable to fund managers under the FIEA.

Prior to the enactment of the FIEA in 2006, investments in partnership-type funds used to be unregulated under the old Japanese securities law, but the FIEA introduced a broad cross-sectoral regulatory regime for a wide range of financial products. In particular, investments in partnership-type funds are categorized as a regulated "collective investment scheme." A general partner ("GP") of this type of fund who (i) marketed the collective investment scheme to Japanese investors or (ii) marketed it in Japan (regardless of whether the investors are Japanese residents or not)[1] is required to be registered as an operator of a Type II Financial Instruments Business (for solicitation of the collective investment scheme (so-called "self-offering")) and an Investment Management Business (for management of funds collected through the collective investment scheme (so-called "self-management")).[2]

However, for such registration, the applicant must meet certain requirements (including the minimum stated capital and appropriate human resources, etc.), which a fund GP could not usually meet, given the GP is usually a special purpose company. Therefore, in order to avoid excess regulations that may harm an innovation in the financial markets, the FIEA also introduced an exemption from such registration requirements for funds aimed mainly for professionals. This is the "Specially Permitted Business for Qualified Institutional Investors" (*tekikaku-kikan-toshika-to-tokurei-gyomu*) (the "Special Business").

More concretely, if a fund meets the following conditions,[3] the fund GP is exempted from the registration requirements as described above, although the GP is required to file only a notification for the Special

Business (the "Notification") with the regulators in advance (Article 63 of the FIEA):

- The fund has at least one Qualified Institutional Investor (a "QII")[4] at all times; and
- The number of investors who are not QII ("Non-QIIs") in the fund is 49 or less.

The exemption is quite commonly used by many fund managers, and according to the FSA, more than 3,000 entities have filed the Notification so far.

Although the Special Business was originally intended for funds aimed at professionals—given its lighter regulations (compared to other businesses that require registration under the FIEA) and the fact that it is permitted to solicit up to 49 Non-QIIs—there were certain incidents where some funds misused the exemption and caused losses to "layman" investors. In response, the Amendments were passed by the Japanese Diet in May 2015 and will come into force as of March 1, 2016.

Outline of New Regulations

Limitation on Non-QIIs Who May Invest in Funds. Before the Amendments, there was no limitation on the nature of Non-QIIs who may invest in a fund, and thus any person (up to 49 persons) might invest in the fund as long as the conditions for the Special Business as described above were met.

Under the Amended FIEA, in order to reinforce the principle that the Special Business is intended for professional funds, besides QIIs, only Non-QIIs with certain limited natures (the "Permitted Non-QIIs") will be permitted to invest in a fund. The Permitted Non-QIIs include, without limitation:

- A listed company;
- A Japanese company with the stated capital or net assets in the amount of JPY50 million or more;
- A foreign company;
- A pension fund holding securities or other investment assets in the amount of JPY10 billion or more;
- An individual who holds securities or other investment assets in the amount of JPY100 million or more and opened his/her securities account more than a year ago; and
- A person/entity having a close relationship with a fund GP (such as a parent, subsidiary, sister company, asset manager, or investment advisor of the GP, and officers and employees thereof).

Whether or not an investor will fall into any of the permitted Non-QII categories must be judged at the time of the marketing of the fund to such investor. According to the FSA, as long as the investor falls into such category at that time, the fund will not lose its status for the Special Business even if such investor later ceases to fall into that category.[5]

In addition to the above, if a fund is categorized as a "venture capital fund,"[6] certain types of persons who are deemed to have knowledge and experience in investments (such as an incumbent or former officer of a listed company, etc.) will also be permitted to invest in the fund.

An operator who already filed a Notification prior to the enforcement of the Amendments (the "Existing Operator") may continue to manage the fund even if the fund has an investor that is not a Permitted Non-QII. However, the Existing Operator will be prohibited from soliciting a new fund to such investor and only will be allowed to solicit the same to QIIs and Permitted Non-QIIs.

Grounds for Disqualification. The Amended FIEA introduces a concept of grounds for disqualification for an operator of the Special Business.

Most notably, a foreign fund manager will be required to appoint a representative located in Japan, who will be a main contact for correspondences with the authorities. According to the FSA's Responses, this does not necessarily mean that the fund manager is required to establish an office in Japan, but it may designate an outside lawyer or certified public account located in Japan as the representative.

In addition, if regulatory authorities on financial instruments in the home jurisdiction of a foreign fund manager have not made any assurance for reciprocity to the FSA,[7] such foreign fund manager will be disqualified for the Special Business.

The requirement of reciprocity in the preceding paragraph will not apply to an Existing Operator. On the other hand, the

requirement of the representative in Japan in the second preceding paragraph will apply to the Existing Operator as well, although the Existing Operator will have a six-month grace period after the enforcement of the Amendments.

Expansion of Conduct Control, Etc. Before the Amendments, an operator of the Special Business was subject to quite limited regulations on conduct control. Only the prohibition on false statements and loss compensation was applicable to the operator. However, under the Amended FIEA, a wide range of regulations (almost equivalent to those to registered operators under the FIEA) will be applicable to an operator of the Special Business. Such regulations include: fiduciary duties to clients; regulations on advertisement; requirement to deliver certain documents to clients before, and at the time of, entering into a contract with them; prohibition on self-dealings; and segregation of funds.[8]

In addition, under the Amended FIEA, an operator of the Special Business will be required to prepare and maintain certain books and records on the Special Business in accordance with the FIEA. In the FSA's Responses, it noted that, as long as the books and records contain items required under the FIEA, the name or formality of the books and records does not matter. Accordingly, we assume that, as long as a fund manager properly prepares and maintains its books and records in accordance with the laws and regulations of the home jurisdiction, such books and records may also satisfy the requirements under the FIEA. However, each fund manager, with the advice of Japanese legal counsel, should carefully review and confirm whether that is the case.

Further, under the Amended FIEA, an operator of the Special Business will be required to annually file the business report (including the details of funds operated by the operator) to the authorities within three months of the end of each fiscal year.[9] The operator is also required to make available to the public an excerpt from the business report by means of the internet or displaying at the office in Japan. Such publicly available excerpt does not contain the details of the fund but contains certain basic information on the funds (such as the name of the funds, the number of investors, the amount invested by QIIs, etc.).

The regulations described in the three preceding paragraphs will apply to the Existing Operator as well without any grace period. Thus, for example, the Existing Operator will be required to file a business report for the business year starting on or after March 1, 2016, within three months after the end of such business year.

Expansion on Contents in Notification. As described above, an operator of the Special Business is required to file a Notification with the regulators before starting the Special Business. The Notification may be in English, and it must contain the name and address of the operator, names of the officers, the name of at least one QII invested in each fund operated by the operator, etc.

Under the Amended FIEA, in addition to the matters described above, the names of all the QIIs invested in each fund operated by the operator must also be included in the Notification.[10] In the case of change in any matters in the Notification, the operator is required to file an amendment to the Notification. Thus, this may impose burdensome obligations to, in particular, the manager of open-ended funds because, in every change in investors who are QIIs, the manager is required to file an amendment.

The Existing Operator will also be required to refile the Notification with the information newly required under the Amendments, together with certain attachments (such as affidavits and resumes of the officers, etc.), within six months after the enforcement thereof (i.e., by the end of August 2016).

Enhancement on Enforcement Powers. The Amendments will enhance enforcement powers by authorities, including the introduction of certain administrative sanctions to an operator of the Special Business (such as a cease and desist order) and the strengthening of criminal penalties for non-filing of a Notification or filing of a false Notification.[11]

Conclusion

As outlined above, the Amendments will significantly tighten regulations on managers of funds marketed to Japanese investors. Thus, it becomes far more important for fund managers who market or plan to market their funds to Japanese investors to take necessary steps or actions to ensure their compliance with the regulations.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

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Endnotes

1 According to the Financial Services Agency of Japan (the "FSA"), although it depends on actual facts and circumstances, it is of the view that, in principle, if funds are only marketed outside Japan to foreign investors who are not Japanese residents, the FIEA is not applicable.

2 Funds formed as corporations or trusts are regulated differently, and this *Commentary* does not cover regulations on corporation- or trust-type funds.

3 For solicitation of fund interests (but not for management of funds), another condition that the fund interests are subject to certain transfer restrictions needs to be met as well.

4 The QIIs under the FIEA include, without limitation, securities firms, banks, and insurance companies.

5 The FSA's responses to public comments to draft enforcement orders and ordinances for the Amended FIEA (the "FSA's Responses") (available only in Japanese).

6 To be categorized as a venture capital fund, the fund needs to meet, among others, the following requirements: (i) more than 80 percent of its investments is to shares or other equity interests in unlisted companies; (ii) the fund does not incur any borrowings and does not provide any guarantees (with some exceptions); and (iii) investors do not have a right to redeem the fund interests.

7 The FSA is a signatory to the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (the "MMoU") of the International Organization of Securities Commissions ("IOSCO"). Thus, if the authorities in the home jurisdiction of a foreign fund manager are also signatories to the MMoU, such condition will be met.

8 As with regulations to registered operators, certain regulations may be lightened if clients are "specified investors" (*tokutei-toshika*) under the FIEA.

9 The business report may be in English. Also, in case of a foreign entity, it may apply for an approval for the extension of the due date of the business report.

10 Under the Amended FIEA, certain information contained in the Notification will be disclosed to the public. However, such information to be disclosed does not include the names of the QIIs.

11 Under the Amended FIEA, an operator who failed to file the Notification or who filed a false Notification may be subject to an imprisonment up to five years and/or fines up to JPY5 million.