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An update on the rules and regulations governing the private placements of fund interests to Japan investors – January 2023

Most recent information regarding the regulatory landscape in Japan.

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Introduction

As we welcome the new year, we have prepared this client alert (this "**Client Alert**") as an update to our previous client alert from July 2019 on the rules and regulations governing private placements of fund interests to Japan investors.

While there have been no significant regulatory developments since which would directly impact capital raising efforts, in this Client Alert, we wish to revisit Japan's regulatory framework to discuss other options for capital raising in Japan.

Specifically, in this Client Alert, we will elaborate on the following:

- (1) supplement our existing overview of the fundamental financial instruments business operator registrations with a discussion of the Securities Sales Intermediary registration (as further discussed below); and
- (2) provide an overview of how the Market Entry Office established by the Financial Services Agency of Japan (the "**JFSA Market Entry Office**") can now be used to seek the Type 2 Financial Instruments Business Operator registration – which can be utilized to market Paragraph 2 Securities in Japan (as further discussed below).

A. The Financial Instruments and Exchange Act of Japan

1. The Four Financial Instruments Business Operator Registrations

The Financial Instruments and Exchange Act of Japan (the "**FIEA**") is the primary regulation in Japan which governs the various financial instruments business activities – including the marketing of fund interests.

Under the FIEA, there are four primary financial instruments business operator registrations:

- (1) Type 1 Financial Instruments Business Operator ("**Type 1 Dealer**");
- (2) Type 2 Financial Instruments Business Operator ("**Type 2 Dealer**");
- (3) Discretionary Investment Management Business Operator ("**DIM**"); and
- (4) Investment Advisory and Agency Business Operator ("**IAA**").

To properly understand the permissible scope of activities under each of the registrations, it is first necessary to understand that "securities" are broadly divided into two separate categories under the FIEA.

Securities defined under Article 2, Paragraph 1 of the FIEA (the "**Paragraph 1 Securities**") are financial instruments such as shares of capital stock companies, bonds, units of investment trusts, shares of investment corporations, warrants and commercial paper. While Paragraph 1 Securities are frequently referred to as liquid securities, liquidity is not a factor in this categorization as the only assessment is on the legal form of the issuer itself.



Securities defined under Article 2, Paragraph 2 of the FIEA (the "**Paragraph 2 Securities**") include beneficial interests of a trust (excluding units of investment trusts), interests in limited partnerships, limited liability partnerships and limited liability companies.¹

As a general matter, any entity wishing to engage in the business of marketing securities to Japan investors must register with the Financial Services Agency of Japan (the "**JFSA**") as either a Type 1 Dealer or Type 2 Dealer depending on the type of security they seek to offer. A Type 1 Dealer is permitted to market Paragraph 1 Securities to Japan investors, while a Type 2 Dealer is permitted to market Paragraph 2 Securities to Japan investors.

The other two major registrations under the FIEA are the DIM registration and the IAA registration.

The DIM registration permits the registrant to engage in a discretionary investment management business – which traditionally refers to the making of trades or investment decisions in Japan ideal for multi-managers that have portfolio investment managers based in Japan. However, in recent years, this registration is increasingly being used by fund managers as an indirect way to raise capital from Japan investors, particularly from Japan pension funds. Specifically, under this "indirect capital raising model", the DIM would enter into a direct investment management agreement with the Japan client (e.g., pension fund) and then using its discretion as a DIM, to invest such client assets in an investment fund that is managed by an affiliate of such DIM.

The IAA registration allows the registrant to conduct two activities – to provide non-discretionary investment advice to a third party about the value of securities and investment decisions; and to act as an intermediary or agent for a party which is entering into investment advisory or investment management agreements.



2. The Securities Sales Intermediary Registration

While not covered in our previous client alert, this Client Alert will also briefly discuss the Securities Sales Intermediary registration ("**Securities Sales Intermediary**" or "**SSI**") as another registration available under the FIEA due to an increased interest in this registration and its significant potential as a capital raising alternative.

Under the SSI registration, through a sponsorship arrangement with a Type 1 Dealer (the "**Sponsor**"²), an applicant that is registered as an SSI is permitted to engage in certain regulated marketing activities without itself being registered as a Type 1 Dealer or Type 2 Dealer. Specifically, in its capacity as an intermediary of the Sponsor, an SSI may market those securities that could be marketed by its Sponsor. In other words, where an SSI is sponsored by a Type 1 Dealer that also holds a Type 2 Dealer registration, such SSI is permitted to act as an intermediary of the Sponsor and market both fund interests that are classified as Paragraph 1 Securities and Paragraph 2 Securities to Japan investors. To be clear, the SSI itself would not be required to be registered as a Type 1 Dealer or a Type 2 Dealer.

It has been our experience that the SSI registration may be a particularly attractive option for fund managers that wish to market Paragraph 1 Securities to Japan investors given the extremely high requirements for the Type 1 Dealer registration – though the SSI registration could be equally viable for the distribution of Paragraph 2 Securities – taking into account the minimal requirements of the SSI itself.

¹ It should be noted that there does not appear to be a single uniform treatment of the interests of limited liability companies under Japanese law. While we are aware that most interests of limited liability companies are classified as Paragraph 2 Securities, there has been some cases where these types of funds have been classified as Paragraph 1 Securities.

² Strictly speaking, a DIM may act as a sponsor for an SSI that seeks to engage in DIM activities. However, given the rarity of this model, we have limited the discussion in this Client Alert to a Type 1 Dealer acting as a Sponsor for capital raising activities.

The most significant attraction of the SSI model is the minimal registration requirements on the SSI itself, particularly in comparison to the requirements of the other primary financial instruments business operator registrations. For example, the SSI registration does not necessarily require a compliance officer in the applicant entity and the SSI registration can be obtained by a company with a single officer or employee.

However, a key aspect of the SSI registration is the link between the SSI and the Sponsor, as applicants seeking to attain the SSI registration will be required to find a Sponsor. As the SSI is ultimately an intermediary for its Sponsor and the Sponsor will bear regulatory responsibility for the activities of the SSI, it is essential for fund managers to identify and partner with a Sponsor that such fund manager can properly synergize with in relation to its Japan capital raising activities.

With the increased interest by Japan investors for credit, debt and similar fixed income type of strategies, whereby the funds are commonly classified as Paragraph 1 Securities thereby necessitating the Type 1 Dealer registration, our team has seen an increase in the fund managers using the SSI model to market these types of products to Japan investors. As we do not anticipate any immediate changes to the requirements to either the Type 1 Dealer registration or the Type 2 Dealer registration, the SSI distribution model may be a viable option for fund managers that seek to market their funds to Japan investors.

B. Private Placement of Fund Interests in Japan

Most offerings in Japan are made through private placements as opposed to public offerings. However, it should be noted that the definition of a "private placement" differs significantly between Paragraph 1 Securities and Paragraph 2 Securities.

1. Private Placement of Paragraph 1 Securities

(1) Definition of Private Placement

Irrespective of whether the Paragraph 1 Securities are being marketed by a Type 1 Dealer or in reliance of some other offering model, a determination must be made as to the specific model of private placement which will be applicable to the offering in question.


Under the FIEA, there are four models of private placement for Paragraph 1 Securities:

- (i) Small Number Private Placement (*shouninzu-shibo*): The marketing entity may make up to forty-nine (49) solicitations to non-qualified institutional investors during any rolling three (3) month period (previously was six (6) months, which has now been updated to three (3) months as of the date of this Client Alert).
- (ii) QII Private Placement (*tekikaku-kan-toushika-shibo*): The distributor may make an unlimited number of solicitations but only to qualified institutional investors ("**QIIs**") with certain transfer restrictions.
- (iii) Hybrid Private Placement (*kakudai-shouninzu-shibo*): The distributor may make up to forty-nine (49) solicitations to non-QIIs during any rolling three (3) month period (previously was six (6) months, which has now been updated to three (3) months as of the date of this Client Alert), and an unlimited number of solicitations to QIIs with certain transfer restrictions.
- (iv) Professional Investor Private Placement (*tokutei-toushika-shibo*): Unlimited number of solicitations but only to professional investors with certain procedural and transfer restrictions.

The election of the specific model of private placement will impact the specific disclosures and transfer restrictions which should be notified and agreed to by Japan investors that are subscribing to the private placement.

(2) The ITICA Notification

Prior to any marketing activities with respect to an investment fund whose interests are Paragraph 1 Securities (i.e., investment corporations or investment trusts), as a general rule, the relevant investment fund must make



a filing to the JFSA, pursuant to the Act on Investment Trusts and Investment Corporations of Japan (the "**ITICA Notification**").

The ITICA Notification is a Japanese language filing that summarizes the material terms of the fund, the Japan offering and its various service providers. The contents of the ITICA Notification are not available to the public as it is strictly for the JFSA's reference for the purposes of tracking which investment funds are being marketed in Japan.

From a black letter law perspective, marketing activities with respect to the relevant fund is prohibited until the fund in question has submitted an ITICA Notification to the JFSA. As there is no prior review by the JFSA of the ITICA Notification, the ITICA Notification can be done quite efficiently, provided that a wide range of deliverables must be submitted with the ITICA Notification (including, but not limited to a legal opinion).

As a final matter, there is an ongoing obligation for the issuer of the ITICA Notification to ensure that contents of the ITICA Notification are accurate and the issuer is required to properly update the ITICA Notification if there are any changes to the contents therein.

(3) *The Bank of Japan Issuance Reports and Redemption Reports*

With respect to the private placement of Paragraph 1 Securities to Japan investors, fund managers should be mindful of certain reporting requirements under the Foreign Exchange and Foreign Trade Act of Japan which may be applicable based on the size of the Japan offering.

(i) Issuance Report

For any corporate or trust type fund which issues interests worth JPY 1 billion or more in a single day to Japan investors, a report must be submitted to the Ministry of Finance through the Bank of Japan ("**Issuance Report**").

The JPY 1 billion threshold is determined based on the subscription price of the securities issued. In cases where the subscription amounts are not paid by the Japan investor on the subscription date, the calculation will be based on capital contributions made (as opposed to capital commitments).

The Issuance Report must be filed with the Bank of Japan within twenty (20) days after the total issuance of the fund exceeds JPY 1 billion in Japan and will also need to be reissued at every JPY 1 billion interval.

(ii) Redemption Report

If a fund had previously filed an Issuance Report in the past as described above, within twenty (20) days after the end of the calendar year, such fund must submit a report ("**Redemption Report**") if: (X) there was any redemption, repurchases or conversion of shares from Japan investors within such calendar year; and (Y) the balance of investments from Japan investors in relation to such fund as of the last day of the calendar year is JPY 1 billion or more.

To be clear, the Issuance Report and Redemption Report are only required for funds whose interests are classified as Paragraph 1 Securities.

2. **Private Placement of Paragraph 2 Securities**

The definition of a private placement varies significantly for Paragraph 2 Securities in comparison to Paragraph 1 Securities as the FIEA defines a private placement of Paragraph 2 Securities as any offering in Japan which has 499 or fewer Japan investors.

It is important to note that unlike the definition of private placements for Paragraph 1 Securities, the Japan investor limitation is based on actual subscriptions by Japanese investors as opposed to solicitations made.

Furthermore, in connection with respect to any offering of Paragraph 2 Securities, specifically limited partnership funds, general partners should properly assess whether it may be required to operate under the Article 63 Exemption in relation to the "self-management" of assets of Japan investors (as discussed in Part C.2 below).

The submission of the ITICA Notification is not necessary for the offering of Paragraph 2 Securities to Japan investors.

C. Common Exemptions from the Registration Requirements

There are certain exemptions which offshore fund managers may seek to rely on in relation to any contemplated fund marketing activities in Japan. While there has recently been a number of new exemptions introduced such as the "Foreign Investor Article 63 Exemption" or the "Foreign Investment Manager Transition Exemption" (both discussed in a previous client alert), this Client Alert seeks to address only those exemptions which are most applicable and relevant for foreign fund managers seeking to engage in capital raising activities in Japan.

For details regarding these recent exemptions, please kindly visit [our previous client alert](#) which discusses these new exemptions in further detail.

1. The Foreign Securities Firm Exception

Article 58-2 of the FIEA allows a foreign securities firm to engage in a limited scope of securities marketing towards a Japan investor without being registered as a Type 1 Dealer or Type 2 Dealer (the "**Foreign Securities Firm Exemption**"). The marketing restrictions imposed by the Foreign Securities Firm Exemption will vary based on the type of investor that the foreign securities firm is seeking to market to in Japan.

Under this exemption, a foreign securities firm is permitted to market to certain types of Japan investors within the QII classification (the "**Permitted QII Investors**") without having to register as a Type 1 Dealer or Type 2 Dealer. The scope of Permitted QII Investors includes, but is not limited to, the following entities: banks, insurance companies, and financial instruments business operators which are engaging in a DIM business under the FIEA.

With respect to any marketing efforts to Permitted QII Investors, this exemption does not allow the foreign securities firm to engage in any onshore marketing activities in Japan (i.e., marketing of the fund during visits to Japan) as this exemption generally limits the foreign securities firm to engage only in offshore marketing activities into Japan (i.e., phone calls or e-mails).

Where the specific investment fund interests sought to be marketed under this exemption are Paragraph 1 Securities, the relevant fund in question would be required to submit an ITICA Notification to the JFSA as this type of activity still constitutes "marketing of securities".

2. The Article 63 Exemption

In connection with the marketing of interests of limited partnership funds (a "**LP Fund**") to Japan investors, a commonly relied on exemption is the "Special Permitted Businesses directed at Qualified Institutional Investors etc." as set forth under Article 63 of the FIEA (the "**Article 63 Exemption**").

The Article 63 Exemption is an exemption applicable to the general partner of a LP Fund with respect to two regulated activities: (i) "self-offering" (*jiko-boshu*) of the interests of the LP Fund to Japan investors without the Type 2 Dealer registration; and (ii) "self-management" (*jiko-unryo*) of the assets of the Japan limited partners that subscribed to the LP Fund without the DIM registration.

As the Article 63 Exemption is not a full registration but a notification filing, the Article 63 Exemption remains to be a popular method used by general partners of offshore LP Funds to distribute their fund interests into Japan without having to register as or otherwise appoint a Type 2 Dealer.

Independent from the discussion with respect to "self-offering" above, the analysis regarding self-management by the general partner of a LP Fund is wholly separate from any discussion about marketing or offering of the relevant LP Fund to Japan investors.

Under Japanese law, only with respect to LP Funds, the general partner is deemed to be providing investment management services to any Japan limited partner that subscribes to such LP Fund. This management activity of the

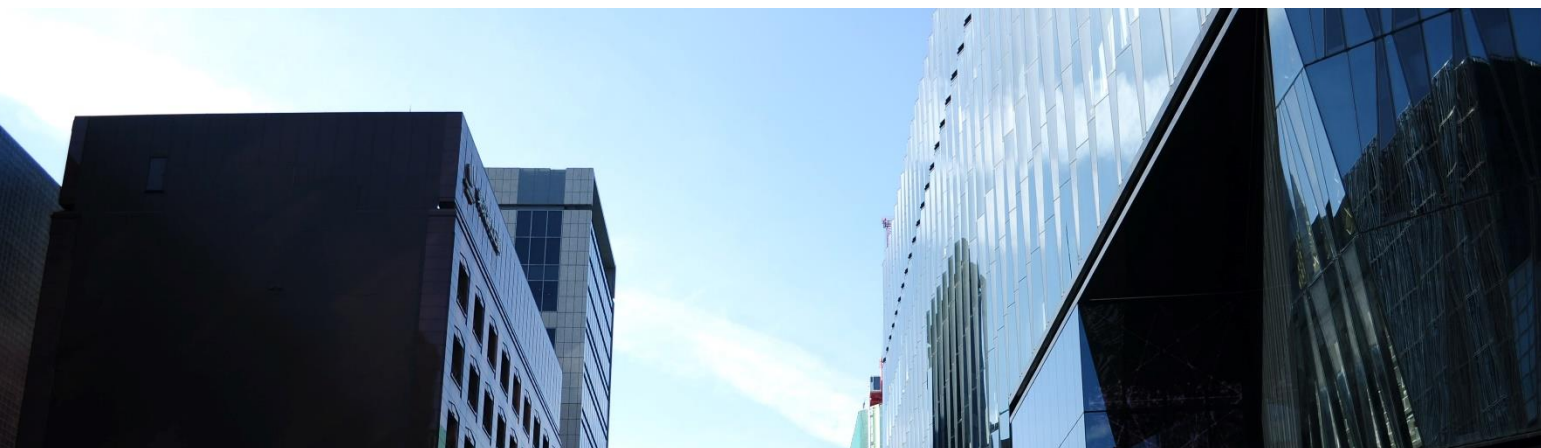
general partner with respect to Japan investors is called "self-management" under the FIEA and specifically refers to cases whereby the general partner manages Japan investors' assets via a LP Fund to primarily invest in "securities and derivatives".

As engaging in self-management activities is a regulated business activity under Japanese law, as a general matter, the general partner is required to either:³ (1) make a filing to the Japan regulator to operate under the Article 63 Exemption; or (2) seek to exempt itself from such characterization as engaging in self-management activities by relying on the "**De Minimis Threshold**" (as described below).

To meet the requirements of the De Minimis Threshold, the relevant LP Fund must satisfy all three of the following requirements with respect to the Japanese investors (on a per LP Fund basis):

- (1) the number of the Japan investors in the LP Fund is less than ten (10);
- (2) all of the Japan investors subscribed to the LP Fund are QIIs; and
- (3) the total capital contributions made by the Japan investors are less than one-third (1/3) of the total capital contributions made by all of the limited partners of the relevant LP Fund.

To be clear, if the relevant LP Fund meets the three requirements of the De Minimis Threshold, the general partner is deemed to be exempt from engaging in "self-management" activities and does not have to operate under the Article 63 Exemption.



D. Overview of the JFSA Market Entry Office

1. The JFSA Market Entry Office

Effective as of January 1, 2021, the JFSA established the JFSA Market Entry Office as part of its efforts to attract foreign business and promoting the investment management industry of Japan.

The purpose of the JFSA Market Entry Office is to ease the overall process by which foreign financial institutions may enter into Japan and seek to register as one of the four financial instruments business operators. The JFSA Market Entry Office provides a wide range of English language support and assistance to foreign financial institutions that are considering establishing an office in Japan and registering with the JFSA to engage in a financial instruments business, as well as certain financial subsidies.

A key feature of the JFSA Market Entry Office is the ability for the applicant to liaise and submit the applicant documentation in English to the Japan regulators.

It also provides various supplementary support services to ease an applicant's entry into Japan, such as visa support and assistance with opening a bank account.

³ In theory, the general partner could also seek to register itself as a DIM or fully delegate investment management authority of the LP Fund to a Japan DIM but given the rarity of these models, we will not specifically cover in this Client Alert.

For a more detailed discussion on the JFSA Market Entry Office, we invite you to visit our [recently published client alert](#) on the JFSA Market Entry Office.

In our original client alert on the JFSA Market Entry Office, there was significant discussion as to a subsidy that was available to new applicants being provided by the JFSA in an amount up to JPY20 million (the "**JFSA Subsidy**"). As of the date of this Client Alert, we are not aware of any formal announcement by the JFSA as to the continuation of the JFSA Subsidy program for the fiscal year starting April 1, 2023 (or, if continued, what form the JFSA Subsidy may take). To err on the side of caution, we recommend that any applicants who are seeking a new registration through the JFSA Market Entry Office to not make any assumptions as to the availability of the JFSA Subsidy and closely liaise with the JFSA Market Entry Office on its availability.

2. Recent Expansion of Capital Raising Opportunities through the JFSA Market Entry Office

Effective as of October 31, 2022, an amendment was made to the JFSA Market Entry Office which expanded the scope of eligible applicants for Type 2 Dealer registrations (the "**Amendment**").

Previously, applicants seeking to register as a Type 2 Dealer through the JFSA Market Entry Office were extremely limited due to the restrictions that were imposed. However, the recent Amendment expanded the scope of applicants seeking to register as a Type 2 Dealer to now include those applicants who will engage in an "**Affiliated Type 2 Business**", where as a Type 2 Dealer: (i) the applicant will only sell interests in limited partnership funds managed by the group companies of the applicant; and (ii) whose target investors will be limited to professional investors (*tokutei toushika*, as defined under Article 2, Paragraph 31 of the FIEA).

This recent Amendment is significant as the scope of activities under the Affiliated Type 2 Business will now allow an applicant to engage in marketing activities for affiliated investment funds, whose interests are classified as Paragraph 2 Securities. This change will likely appeal to larger institutional investment managers who can now utilize the JFSA Market Entry Office to register as an Affiliated Type 2 Business, for the purpose of distributing the interests of their wide catalogue of affiliated investment funds in Japan.

For a more detailed discussion on the recent Amendment to the JFSA Market Entry Office, we invite you to visit our [recently published client alert](#) on the Amendment.

E. Conclusion

Despite the complexities of the Japanese regulatory framework, capital-raising activities continue to increase in Japan particularly in this post-COVID environment. Japan investors and investment allocators are increasingly looking to offshore fund managers to achieve target returns and Japan is expected to continue to be a key allocator for investment funds in the future. Knowing how to navigate the regulatory landscape in Japan will thus be essential for offshore fund managers to engage in successful capital raising activities in Japan.

If you have any questions, please feel free to reach out to [Koji Yamamoto](#), and [Yoshiyuki Omori](#) for a consultation.

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