

STRUCTURED FINANCE BULLETIN

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Proposed Reform of the Article 63 Exemption under the FIEL - from a real estate fund practice perspective -

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Eriko Ozawa
+81 3 5220 1816
eriko.ozawa@mhmjapan.com |
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I. Release of Financial System Council's Working Group Report

On January 28, 2015, the Financial System Council's working group on investment management (the "WG") released a report discussing a revised system for funds targeting professional investors for the protection of investors and procurement of funds for economic growth (the "WG Report").¹ The WG Report calls for the reform of a collective investment scheme that uses the QII²-targeted fund business exemption (the "QII-targeted Fund Exemption") under Article 63 of the Financial Instruments and Exchange Law of Japan (the "FIEL"), which is often implemented in the form of a "GK-TK structure" in the current real estate fund practice in Japan.

It is expected that the provisions on the QII-targeted Fund Exemption in the FIEL and the FIEL Cabinet Order, Cabinet Ordinance and guideline will be amended based on the proposals contained in the WG Report.

This note highlights key issues with certain proposed amendments that are particularly relevant to the real estate fund practice.

¹ The Japanese text of the WG Group is available at the website of the Financial Service Agency of Japan (the "FSA") at:

http://www.fsa.go.jp/singi/singi_kinyu/tosin/20150128-1.html and
<http://www.fsa.go.jp/news/26/syouken/20150128-2.html>

² "QII" is an abbreviation of a "Qualified Institutional Investor" under the FIEL.

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II. Background of the proposed reforms

Under the current Article 63 of the FIEL, a person operating a business that qualifies for the QII-targeted Fund Exemption (a “**QII-targeted Fund Operator**”) needs only to file a notification with the local financial bureau with jurisdiction over the QII-targeted Fund Operator in order for it to be exempted from the registration requirement for conducting an investment management business. The FIEL imposes on a QII-targeted Fund Operator only a few of the restrictions and impositions on the conduct of business that are generally applied to investment managers.

However, there were several scandals involving unsophisticated investors who suffered losses from investing in funds that invoked the QII-targeted Fund Exemption.³ As such, on May 14, 2014, the FSA released to the public for comment the proposed drafts (the “**May 2014 Proposed Drafts**”) of the amendments to the FIEL Cabinet Order, Cabinet Ordinance and guideline, which limited the scope of investors permitted to invest in funds invoking the QII-targeted Fund Exemption. Such amendments were scheduled to take effect on August 1, 2014.

The FSA received a number of public comments against the May 2014 Proposed Drafts, and decided to put the May 2014 Proposed Drafts on hold. In October 2014, the WG was organized under the FSA’s Financial System Council to conduct a comprehensive review of the QII-targeted Fund Exemption. The WG Report summarizes the discussions at the WG sessions.

III. Possible impacts on real estate fund practice

Unlike the May 2014 Proposed Drafts, the WG Report goes beyond limiting the scope of investors permitted to invest in funds invoking the QII-targeted Fund Exemption. It proposes to impose additional requirements to qualify for the QII-targeted Fund Exemption, continuing qualification requirements for QIIs, and further restrictions and impositions on the conduct of the QII-targeted Fund Operator’s business. It also seeks to enhance the regulatory powers of governmental agencies over QII-targeted Fund Operators.

³ Based on reports, most of those problematic funds involved very small investments from QIIs, and most of the investments were made by individual unsophisticated investors.

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It is expected that, aside from the FIEL Cabinet Order, Cabinet Ordinance and guideline, the FIEL itself will be amended to make these comprehensive reforms; whereas, in the May 2014 Proposed Drafts, only the FIEL Cabinet Order, Cabinet Ordinance and the guideline were intended to be amended.⁴

The amendments could affect the typical GK-TK structure in the following ways:

- (1) QII-targeted Fund Operator will be subject to certain personnel requirements.

In the current real estate fund practice, most QII-targeted Fund Operators are organized in the form of a *godo kaisha* (a “GK”), which is structured as a special purpose company without substantial human resources to operate its business. Instead, the GK entrusts most of its business operations to an asset manager, which must be an investment advisor or investment manager registered under the FIEL.

It may be difficult for the managing member of a GK to find a dedicated operating officer (*shokumu shikko sha*) for the GK, especially if the law or regulations require that the officer possess certain credentials or qualifications. It may be easier for the managing member of a GK to appoint an operating officer if such appointment were only limited by a list of disqualifications, similar to the case of directors in a *tokutei mokuteki kaisha* (Article 70 of the Asset Liquidation Law).

- (2) The items required to be provided in, and the documents required to be submitted together with, the notification for the QII-targeted Fund Exemption will be expanded. In addition, the contents of the notification and certain materials outlining the business of the QII-targeted Fund Operator will be disclosed to the public, by reference to U.S. practice.

Under the current practice, the QII-targeted Fund Operator is only required to file with the local financial bureau a short notification form, a copy of its corporate registration certificate, and a one-page outline of its business.⁵ This is not especially burdensome on the GK.

⁴ Note that there will be no public comment process for any amendments to the FIEL itself, unlike the FIEL Cabinet Order, Cabinet Ordinance and guideline, which can only be amended after going through a public comment process.

⁵ In the case of the GK filing a notification with the Kanto Finance Bureau, Tokyo Local Finance Office.

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Depending on the level and scope of the expansion and disclosure and the availability of any exceptions to real estate funds, the QII-targeted Fund Exemption may become too burdensome or costly to be used or, in the worst case, impracticable.

- (3) A limited partnership for investment (*toshi jigyo yugen sekinin kumiai*) (an “LPI”) will be required to have and maintain a certain amount of assets to be and remain qualified as a QII. If it invests in a QII-targeted Fund Operator, its continuing qualification as a QII may be necessary for the fund to remain exempted under the QII-targeted Fund Exemption.

In particular, the WG Report proposes to set a minimum asset balance of JPY 500 million,⁶ which balance excludes borrowed money.

The WG Report states that a QII that invests in a QII-targeted Fund Operator must continue to be qualified as a QII throughout the term of the fund. Based on this statement, an LPI that invests as a QII in a QII-targeted Fund Operator may be required to maintain the minimum asset balance as long as it is involved in the fund.

- (4) A QII-targeted Fund Operator will be subject to certain restrictions and impositions on the conduct of its business, which will be similar to those imposed on financial instruments business operators registered under the FIEL. However, some restrictions and impositions will not apply to a QII-targeted Fund Operator if it receives investments only from sophisticated investors (*i.e.*, specified investors (*tokutei toshika*) under the FIEL).

Under the current FIEL regime, QII-targeted Fund Operators are subject to only two restrictions on the conduct of their business: first, prohibitions on false explanation and second, prohibitions on compensation for losses (Article 63, paragraph 4 of the FIEL).

The WG Report proposes subjecting QII-targeted Fund Operators to the following additional restrictions and impositions:

⁶ In the WG Report, it is proposed that, if a newly-established LPI makes its first investment in a QII-targeted Fund Operator, such LPI will be required to submit a document evidencing its plan of acquisition of assets to satisfy the minimum asset balance requirement prior to submitting additional documents evidencing its asset balance.

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- fiduciary duty and duty of care of a good manager
- obligation to manage the fund's assets separately from other assets
- prohibitions on making a transaction that would harm investors' interests
- principles of suitability*
- prohibitions on providing investors with conclusive evaluations
- delivery of documents prior to or upon execution of contracts*
- delivery of an investment report*

(The items with asterisks will not apply to QII-targeted Fund Operators that receive investments only from sophisticated investors.)

Furthermore, the WG Report proposes to require QII-targeted Fund Operators to explain to investors the nature of the risks in its business and the limitation on who can invest in a QII-targeted Fund Operator. The QII-targeted Fund Operator must also prepare and deliver to the relevant authority a business report, and prepare and maintain certain books and records.

(5) The scope of "non-QII" investors who can invest in a QII-targeted Fund Operator will be limited.

The current FIEL does not restrict non-QII investors from investing in a QII-targeted Fund Operator as long as the number of non-QII investors in a fund does not exceed 49. The WG Report proposes to limit the scope of non-QII investors who may invest in a QII-targeted Fund Operator, although such limitation appears less stringent than those proposed in the May 2014 Proposed Drafts.

The WG Report proposes to allow non-QIIs to invest in a QII-targeted Fund Operator if they are either sophisticated enough to make an investment decision (such as a corporation having capital and assets in excess of a certain threshold), or closely involved with the QII-targeted Fund Operator (such as its asset manager or the asset manager's directors). The WG Report also proposes to subject the investment of non-QIIs that are closely involved with the QII-targeted Fund Operator to a certain limit.

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IV. Looking ahead

Generally speaking, the WG Report has been received favorably in that the proposed scope of permitted investors is broader than that proposed under the May 2014 Proposed Drafts. However, it now includes amendments to strengthen the regulations on QII-targeted Fund Operators, which could be challenging for funds that do not have the resources in place to comply with the amended regulations.

While the scope of permitted investors was not especially important to real estate funds, whose investor base usually consists of more sophisticated investors, the imposition of more stringent requirements and regulations on QII-targeted Fund Operators is a significant issue. Many real estate fund structures involve QII-targeted Fund Operators that only serve as conduits for holding assets, and do not require any human resources or conduct any other activities. If the amendments to the FIEL and the FIEL Cabinet Order, Cabinet Ordinance and guideline are consistent with the proposals in the WG Report, we can expect that some changes in the real estate fund practice in Japan will emerge as a result of these reforms.

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(Contacts)
Public Relations
mhm_info@mhmjapan.com
+81-3-6212-8330
www.mhmjapan.com