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Major Changes to the Fund Distribution Exemption in Japan: *The Amendment to the FIEA's Article 63 Exemption*

An amendment to the Financial Instruments and Exchange Act¹ (the FIEA) was promulgated on June 3, 2015, and went into effect on March 1, 2016 (the Amendment). One of the main purposes of enacting the Amendment was to tighten regulations on fund distribution and management businesses with an Article 63 exemption (the Exemption). Such funds are generally known as Article 63 exempt businesses (the Exempt Businesses).

Background

Under the FIEA, any investment fund intending to market securities to Japanese residents or to manage assets contributed by Japanese residents is generally required to register as a Financial Instruments Business Dealer (FIB Dealer). Yet, under the Exempt Business structure, a general partner (the GP) may manage and market a limited partnership-structured investment fund without obtaining an FIB Dealer's registration, so long as the fund meets certain requirements. Such requirements include subscribing at least one qualified institutional investor (QII) and placing certain limitations on the number of non-QIIs invested in the fund, among others.

The Exemption has gained popularity among fund managers, because under the Exempt Business structure, an Exempt Business GP receives minimal supervision by Japanese regulators. Further, the Exempt Business GP is only required to provide a mere notification (the Notification) to Japanese regulators containing minimal information about the Exempt Business, and maintain minimal ongoing regulatory requirements.

However, despite the benefits of the Exempt Business structure, there has been some controversy. In recent years, reports have surfaced of Exempt Business GPs engaging in fraudulent marketing and other improper business activities resulting in

¹ Act No. 25 of 1948, as amended.

investor losses. Such misconduct led to the Amendment, which intends to strengthen investor protections by tightening regulations on Exempt Businesses. Exempt Businesses are now subject to regulations and reporting obligations that are, while still moderate, more akin to the full regulations and reporting requirements of FIB Dealers.

Key Features of the Amendment

Some of the key features of the Amendment include additional requirements concerning Notifications, reporting, disclosures, and eligibility of Exempt Business GPs and investors. An overview of some of the new requirements under the Amendment is provided below.

Notifications, Reporting, and Disclosures

> Notifications

All new and existing Exempt Business GPs, including those who have submitted a Notification using the old form prior to enactment of the Amendment, must submit Notifications using the new form prescribed under the Amendment by the end of August 2016. The new form requires some additional pieces of information previously unnecessary on the old form. Additional information includes the name, address, and telephone number of the Exempt Business's designated representative in Japan, and the name and type of all the Exempt Business's QII investors.

The new form also requires additional attachments demonstrating that funds and GPs fulfill the requirements of Exempt Businesses. Attachments include written oaths of GPs, directors and senior officers pledging they meet certain eligibility requirements; résumés of directors, and other relevant employees; documents evidencing the ratio of amounts invested by certain non-QIIs; and others.

> Reporting

GPs of Exempt Businesses are now required to submit an annual business report (the Annual Business Report) to regulators each business year. The business report must contain certain information concerning the Exempt Business, such as financial information and information on the QIIs.

> Disclosures

Exempt Business GPs must now disclose certain information contained in the Notification to the relevant local finance bureau. Further, GPs of Exempt Businesses must also produce and publicly disclose an annual report containing certain information from the Annual Business Report.

Eligibility of GPs

The Amendment includes certain eligibility requirements an Exempt Business GP needs to satisfy in order to obtain an Exemption. One requirement is that a GP intending to file an Exempt Business Notification must not fall under any of the causes for disqualification included in the Amendment. For example, a person or entity that was ordered to abandon an Exempt Business or was subject to criminal punishment within the most recent five (5) years is disqualified from engaging in an Exempt Business as a GP.

An additional requirement is that a foreign GP must designate a "representative in Japan." A representative in Japan must be a Japanese resident who is able to contact both the relevant authorities and the GP. The representative does not need to be an individual employed by the GP, and according to the FSA, it is possible for the GP to appoint an outside attorney or accountant in Japan to fill that role.

Eligibility of Non-QIIs

> General

The Exempt Business structure requires at least one QII to invest in the Exempt Business. So long as at least

one QII is subscribed in the Exempt Business, the GP can sell fund interests to up to 49 non-QIIs.

Prior to the Amendment, there was no limitation on the types of non-QIIs eligible to invest in an Exempt Business. However, the Amendment imposes new limits on the types of non-QIIs that may invest. Eligible non-QIIs include, but are not limited to, the following:

- (i) Listed companies;
- (ii) Foreign corporations;
- (iii) Domestic corporations with JPY 50 million or more of stated capital; and
- (iv) Individual investors with JPY 100 million or more of financial assets who have held a securities account at a broker for more than a year.

> *Venture Funds*

Notwithstanding the non-QII eligibility requirements listed above, the JPY 100 million requirement for individual investors does not apply to certain individual investors, such as directors and major shareholders of listed companies, when they invest in a certain type of venture fund under the Exempt Business structure. Such individual investors, even if they possess financial assets of less than JPY 100 million, are also eligible to invest in such venture funds under the Exempt Business structure.

Administrative Sanctions and Penalties

Relevant Japanese regulators have the authority to order improvements, suspensions, or the abolishment of an Exempt Business. Moreover, for any GP who either fails to file the necessary Notification or amendment notification, or files a fraudulent one, a maximum penalty of five (5) years imprisonment may now be imposed under provisions of the Amendment.

End Note

The purpose of this memorandum is to provide a general overview of the Amendment to Article 63. It is not intended as a comprehensive and detailed analysis on all of the provisions of the Amendment that may apply to each type of fund. When considering an Article 63 Exemption, it is important for each fund to consider its own unique circumstances and goals. Also, it is important to keep in mind that there are some processes and requirements that are not clearly stated in the relevant laws and regulations, which regulators customarily request or require from Exempt Businesses. Therefore, if you would like additional information on the Article 63 Exemption that may be relevant to your fund, please feel free to contact your Greenberg Traurig attorney.

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