

The Impact of Recent Amendments to the Article 63 Exemption on Partnership-Type Funds in Japan

Article 63 of the Financial Instruments and Exchange Act of Japan (the "**FIEA**") provides an exemption from the licensing requirements applicable to the marketing and investment management activities of partnership-type funds in Japan (known as "Special Exempt Business for Qualified Institutional Investors, etc." (*tekikaku kikan toshika tou tokurei gyomu*)). Many partnership-type funds operate under this exemption (the "**Article 63 Exemption**") as an alternative to complying with the strict licensing requirements under the FIEA. In May 2015, in response to reported abuses of the Article 63 Exemption, resulting in Japanese retail investors suffering financial losses, the National Diet of Japan passed a bill amending Article 63. On 3 February 2016, the Japan Financial Services Agency (the "**JFSA**") published its responses to comments on the amendments received during the public consultation period (as well as the relevant Enforcement Order and Cabinet Office Ordinance finalising the amendments).

This Client Briefing outlines the amendments to the Article 63 Exemption, which came into effect on 1 March 2016, and their impact on partnership-type funds currently operating under the exemption.

What is the Article 63 Exemption?

The Article 63 Exemption is available to collective investment schemes such as limited partnerships. The general partner of a limited partnership will typically rely on the Article 63 Exemption to gain exemption from the licensing requirements applicable to the following activities:

- marketing interests in the limited partnership, which otherwise requires a licence as a Type II financial instruments business operator (*dainishu kinyu shohin torihiki gyousha*); and
- investing investor funds or assets in securities or derivative transactions, which otherwise requires a licence as an investment manager (*toushi unyou gyousha*).

Prior to the amendments, a general partner was able to rely on the Article 63 Exemption by submitting a notification to the regulator (the "**Article 63 Notification**") provided that the investor base (i) included at least one Qualified Institutional Investor (*tekikaku kikan toshika*) ("**QII**"), and (ii) had no more than 49 non-QII investors and (ii) did not include certain types of investors.

However, under the amendments, the requirements for relying on the Article 63 Exemption have become more complex and restrictive due to various measures that have been introduced to safeguard investors' interests.

What are the key changes to the Article 63 Exemption?

The key changes to the Article 63 Exemption relevant to partnership-type funds are as follows:

1. Restrictions on availability of Article 63 Exemption
 - (a) Scope of Non-QII Investors
 - (b) Use of Investment Limited Partnerships (*toshijigyo yugensekinin kumiai*) as QIIs
 - (c) Proportion of funds invested by non-QIIs
 - (d) Appointment of a representative in Japan
 - (e) Assurance by foreign regulator in respect of cooperation with administrative investigations by the JFSA
2. Expansion of scope of (a) information and document submission and (b) publication of information
3. Impact on funds already operating under Article 63 Exemption
 - (a) Expanded Code of Conduct
 - (b) Books and Records, Business Reports, and Summary Documents
 - (c) Greater Power to Regulatory Authorities

A brief discussion of each of these changes in the context of partnership-type funds is set out below.¹

1. Restrictions on availability of Article 63 Exemption

(a) Restriction on the scope of non-QII investors

Prior to the amendments, the main requirement for relying on the Article 63 Exemption related to the number of investors in the fund (i.e., at least one QII and no more than 49 non-QII investors). However, under the amendments, the scope of "non-QII" investors has been limited to certain types of individuals and entities (the "**Eligible Non-QII Investors**") such as:

- financial instruments business operators;
- registered financial institutions;
- listed companies;
- companies with net assets or capital of JPY 50 million or more;
- special purpose companies (*tokutei mokuteki kaisha*);
- companies incorporated outside Japan;
- partnership-type funds established outside Japan; and
- parties closely associated with the applicant for the Article 63 Exemption (the "**Article 63 Business Operator**") (e.g. a parent company, an affiliated company or a subsidiary company).²

(b) Restriction on including Investment Limited Partnerships (*toshijigyo yugensekinin kumiai*) as QII

Under the amendments, the scope of the QII concept has been tightened in respect of the use of an "Investment Limited Partnership" (*toshijigyo yugensekinin kumiai*) as a QII. An "Investment Limited Partnership" (*toshijigyo yugensekinin kumiai*) must now have net assets of at least JPY 500 million in order to qualify as a QII. This means that the Article 63 Exemption will not be available if there is no QII other than an investment limited partnership with net asset under JPY 500 million. This restriction was introduced in response to problems associated with the use of investment limited partnerships lacking any substantial assets as QII.

¹ Please note that venture funds are given certain special treatment under these amendments. However, this is out of the scope of this Client Briefing which focuses on funds that are not venture funds.

² This is not an exhaustive list.

(c) Restriction on the proportion of funds invested by non-QIIs

Under the amendments, the Article 63 Exemption is not available where non-QIIs closely associated with the Article 63 Business Operator (e.g. a parent company, an affiliated company or a subsidiary company) contribute 50% or more of the total assets to the fund. This restriction was introduced to avoid the abuse of the Article 63 Exemption by having the majority of the non-QII investor base coming from the same group as the Article 63 Business Operator.

(d) Appointment of a representative in Japan

Under the amendments, offshore Article 63 Business Operators will be required to appoint "a representative in Japan". Although the meaning of "representative in Japan" is unclear in the FIEA, the JFSA has clarified that the representative in Japan will be expected to liaise with the Japanese authorities on behalf of the offshore Article 63 Business Operator, and that a physical presence or personnel in Japan is not required. The JFSA has stated that third party service providers such as lawyers or certified public accountants in Japan may be appointed to act as the offshore fund's representative in Japan.

(e) Assurance by the foreign regulator in respect of cooperation with administrative investigations by the JFSA

Under the amendments, offshore Article 63 Business Operators will be required to receive assurances from the relevant foreign financial regulator responsible for the enforcement of foreign laws and regulations equivalent to the FIEA (either in the country of its main office or in the country from where it intends to operate the exempt business) that the foreign regulator will accommodate any requests by the JSFA for cooperation in respect of administrative investigations conducted by the JSFA for the purpose of enforcing Japanese law. According to the JFSA, this requirement will be satisfied where the foreign regulator is a signatory of the International Organization of Securities Commissions (the "IOSCO") Multilateral Memorandum of Understanding.

However, Article 63 Business Operators that qualified for the Article 63 Exemption prior to 1 March 2016 will not be subject to this requirement.

2. Expansion of scope of (a) information and documents to be filed with the authorities and (b) public disclosure of certain information

(a) Expansion of the scope of information and documents to be filed with the authorities

Under the amendments, Article 63 Business Operators will be required to include the following additional information in the Article 63 Notification:

- the name and location of the office where the exempt business will be operated;
- the content of the exempt business;
- the names, type and total number of QIIs; and
- (in the case of venture funds) the name of their publicly certified accountant or auditor.

Additional ancillary documents must also be submitted together with the Article 63 Notification including:

- a written oath stating that no disqualification events exist;
- the Articles of Incorporation (*teikan*) and certificate of registered information (*tokijiko syomeisyo*) (or equivalent documents);
- the CVs and copies of residence certificates of the officers (*yakuin*) and other key employees;
- certification (or equivalent documentation) that the officers (*yakuin*) and employees are not supported by guardians or conservators;
- where the QII is an Investment Limited Partnership, documents showing the amount of its net assets and liabilities (see Section 1(b) above); and
- documents showing the total amount invested by certain non-QIIs closely associated with the applicant or by certain non-QIIs with knowledge and experience pertaining to the investments by the applicant (see Section 1(c) above).

(b) Publication of information in the Article 63 Notification

Under the amendments, each Article 63 Business Operator will be required to make available for public inspection at its head office and offices in Japan where it will conduct its exempt business the information in the Article 63 Notification (other than the names of the QIIs and, in case of an offshore entity, information relating to its representative in Japan) or otherwise publish such information on its website. This information must be made available and/or published without delay after the Article 63 Notification is made. It should be noted that an Article 63 Business Operator located only outside Japan has to use the internet for the publication of such information by making it available on the website of such Article 63 Business Operator or a third party service provider in Japan.³

3. Impact on funds operating under the Article 63 Exemption

(a) Expanded Code of Conduct

Under the amendments, each Article 63 Business Operator will be subject to an expanded Code of Conduct and additional obligations, including obligations to provide explanatory documents to investors prior to and at the time of entering into investment agreements, to comply with investor suitability principles, to segregate investor assets, to provide investment reports (*unyo hokoku sho*) and to avoid conflicts of interest.

However, where the investors are professional investors (*tokutei tousehika*), the Article 63 Business Operator will be exempt from certain of these obligations as well as the obligation to provide investors with an investment report in respect of any relevant transactions. It should be noted that the Article 63 Business Operator is required to notify any professional investors that they may, upon request, be treated as non-professional investors (unless they are QIIs, the Japanese government, or the Bank of Japan).

(b) Books and Records, Business Reports, and Summary Documents

Under the amendments, Article 63 Business Operators will be required to prepare and (where applicable) retain certain documents for the period of time prescribed in the Cabinet Office Ordinance.

For example, each Article 63 Business Operator will be required to:

- prepare a business report (*jigyo hokokusho*) for each financial year beginning on and after 1 March 2016 and submit the business report to the regulator within three months of the end of each financial year;
- prepare a summary document (*setsumei shoru*) of the information in the business report prescribed in the Cabinet Office Ordinance as necessary for protecting investors' interests and make the summary document available for public inspection at the head office and offices in Japan where exempt business is conducted or publish the summary document on its website, in each case, within four months of the end of each financial year. (Alternatively, the Article 63 Business Operator may publish a copy of the business report instead of the summary document.); and
- retain explanatory documents provided to investors prior to and at the time of entering into investment agreements for five years, and customer ledgers and portfolio management reports for ten years.

It should be noted that, subject to certain requirements being satisfied, an offshore Article 63 Business Operator can request that the JSFA grant an extension of the deadline for submitting the business report and/or publishing the summary document. In addition, any relevant books and records, business reports, and summary documents may be prepared in English.

³ The JFSA does not exclude methods other than the internet, but it requires the publication method to enable investors to access the information easily at all times. It is difficult to imagine a method other than the internet.

(c) Increased supervisory power of the regulator

Under the amendments, the JSFA may issue orders to Article 63 Business Operators, including orders to improve, suspend or wind up their fund business. The JSFA may also inspect the offices of Article 63 Business Operators as well as request that they submit certain reports and materials to the JSFA.

How will the amendments affect funds established prior to 1 March 2016?

Article 63 Business Operators that qualified for the Article 63 Exemption prior to 1 March 2016 ("**Current Article 63 Business Operators**") can, in respect of funds solicited prior to 1 March 2016, continue to operate the exempt business until the business terminates.

However, Current Article 63 Business Operators will be required to comply with the amended Article 63 and the restrictions therein in respect of any marketing and investment management activities relating to new funds solicited on or after 1 March 2016 (see Section 1 above).

The following table summarises the impact of the amendments to the Article 63 Exemption on Current Article 63 Business Operators.

The effect of the amendments on Current Article 63 Business Operators

Items	Relevant Date	Comments
(a) Grandfathering treatment of capital calls and investment management	1 March 2016	If investors in the existing fund are required to meet capital calls without any conditions, the Current Article 63 Business Operator can make the capital calls and manage the invested funds without complying with the amended Article 63. However, if the investors are not required to meet capital calls, the Current Article 63 Business Operator will be subject to the amended Article 63 and the restrictions therein in relation to the availability of the Article 63 Exemption (see Section 1 above).
(b) Appointment of a Representative in Japan	31 August 2016 (6 months' grace period)	Current Article 63 Business Operators will be required to appoint a representative in Japan <u>on or before 31 August 2016</u> . The representative may be a third party service provider such as a lawyer or certified public accountant in Japan.
(c) Filing of the New Notification	31 August 2016 (6 months' grace period)	Current Article 63 Business Operators will be required to file a Notification based on the new format (the " New Notification ") <u>on or before 31 August 2016</u> . This New Notification may be prepared in English.

Items	Relevant Date	Comments
(d) Filing of ancillary documents to the New Notification	31 August 2016 (6 months' grace period)	<p>Current Article 63 Business Operators will be required to submit the following ancillary documents together with the New Notification:</p> <ul style="list-style-type: none"> - a written oath stating that no disqualification event exists; - their Articles of Incorporation (<i>teikan</i>) and certificate of registered information (<i>tokijiko syomeisyo</i>) (or equivalent documentation); and - CVs and copies of residence certificates (<i>gyumin hyo</i>) of the officers and other key employees. <p>These documents may be prepared in English.</p>
(e) Publication of Information in the New Notification	Without delay after filing the New Notification (which must be submitted by 31 August 2016)	<p>Certain information contained in the New Notification must be made available for public inspection <u>without delay after the filing</u>. Current Article 63 Business Operators that do not have offices in Japan will have to use the internet for the publication of such information by making it available on the website of the Current Article 63 Business Operators or a third party service provider in Japan. This information may be published in English.</p>
(f) Expanded Code of Conduct	1 March 2016	<p>Current Article 63 Business Operators will be subject to the expanded Code of Conduct without any grace period. The JFSA has emphasised that Current Article 63 Business Operators will need to take necessary steps to operate their existing exempt business in compliance with the expanded Code of Conduct (subject to certain exemptions where the investors are professional investors (<i>tokutei touseika</i>)).</p> <p>Where the investor base comprises both professional and non-professional investors and such investors are entities (as opposed to individuals) without QII status, Current Article 63 Business Operators may wish to consider asking such non-professional investors to convert to professional investors in accordance with the procedure provided under the FIEA. The benefits of conversion include, for example, that Current Article 63 Business Operators will not be required to prepare an investment report (<i>unyo hokoku sho</i>) in respect of the items prescribed in the FIEA.</p>
(g) Books and Records, Business Reports, and Summary Documents	1 March 2016	<p>Current Article 63 Business Operators will be required to comply with the same documentation and reporting obligations applicable to the Article 63 Business Operators described in Section 3(b) above. These documents may be prepared in English.</p>

How will the amendments affect current fund practice and fund documentation?

The amendments to the Article 63 Exemption will have a significant impact on partnership-type funds established both before and after 1 March 2016. As outlined above, the amendments not only restrict the availability of the Article 63 Exemption but also impose more stringent obligations on funds relying on the exemption. Some general observations as to the impact of the amendments on current funds practice are set out below.

Offshore funds

Offshore partnership-type funds will be required to appoint a representative in Japan in order to rely on the amended Article 63 Exemption.

Fund Documentation

Article 63 Business Operators will be required to disclose additional information in relation to the fund and accordingly the entity will need to consider whether the confidentiality clauses in the relevant fund documents (e.g., partnership agreement) permit such disclosure.

In relation to fund documentation, we expect that various changes to the documentation of existing and/or new funds may be required to reflect the amended Article 63 Exemption, including:

- updating investor representations and warranties in relation to the status of the investor and transfer restrictions to address the new restrictions on the scope of non-QIIs and the proportion of funds that can be invested by non-QIIs;
- including specific obligations on the Article 63 Business Operator to comply with the expanded Code of Conduct;
- updating confidentiality provisions to accommodate the new public disclosure requirements; and
- providing for a procedure to convert non-professional investors (if any) to professional investors (if applicable) so that the more stringent obligations applicable in respect of non-professional investors in the Code of Conduct (e.g. the requirement to prepare investment reports (*unyo hokou sho*)) do not apply.

Looking ahead...

Although the amended Article 63 Exemption remains useful for partnership-type funds, going forward it will be important for funds to consider the impact of the amendments, the additional requirements for relying on and complying with the Article 63 Exemption, as well as other alternatives for structuring funds in Japan.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

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