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Japan Regulatory Update

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The GPIF Act will be amended to allow GPIF to directly invest into Limited Partnerships

While Japan's Government Pension Investment Fund ("**GPIF**") is currently prohibited from making direct investments into a limited partnership fund ("**LP Fund**"), amendments are expected to be made to the Enforcement Order with respect to the Act governing the Government Pension Investment Fund (the "**Enforcement Order**") to remove this restriction. As GPIF is the largest pension fund in the world with approximately 130 trillion yen in assets,[1] it is viewed as one of the most prestigious allocators in Japan. Both Japanese and foreign investment managers are closely monitoring the outcome of the proposed amendments which will expand the types of investments that GPIF will be permitted to make.

A. BACKGROUND

Historically, GPIF has held a unique position as an allocator due to the fact that it is an independent administrative agency of the Japanese government and holds assets which have been contributed by the work force for the benefit of pension recipients in the future.

In light of the foregoing, the investment activities of GPIF are subject to specific rules and regulations, including but not limited to, the following:

(i) GPIF shall not make any investment which may give rise to the appearance that GPIF is controlling the management of a private company (through holding of shares, exercising of voting rights, etc.);

(ii) GPIF shall not make any speculative investments to secure funding of future pension benefits; and

(iii) GPIF shall not, through its investment activities, distort or unduly influence the price determination function of the market.[2]

As a result of such rules and regulations, GPIF had historically engaged in "in-house management" with respect to a portion of its passive investments (i.e., investment strategy to follow the benchmarks) of domestic bonds. Separate from such in-house management, GPIF has historically delegated investment management authority of its assets to trust banks and investment managers with respect to investments into other types of assets (e.g. shares).[3]

The highlight of the amendments is the addition of interests of LP Funds ("LP Interests") to the list of "Alternative Assets" (i.e., assets other than traditional assets such as bonds or shares issued in or outside of Japan) – which is a list of the types of securities that GPIF may invest in directly through its in-house management.[4] Specifically, it is expected that LP Interests will be added to the relevant article of the Enforcement Order which designates those securities that GPIF may invest in through its in-house management while additional requirements described in Part C below

1 As of the end of first quarter of fiscal year 2016, page 1 of the "Investment Results for the first quarter of fiscal year 2016".

2 See pages 14-17 of "About GPIF" dated Feb. 8, 2016 by the Pension Bureau of the Ministry of Health, Labor and Welfare, etc.

3 The GPIF website: FAQ #4 "How the assets are managed?" 3. "Who is managing".

4 "Addition of Investments into Alternative Assets by the GPIF (investments into LP)" dated July 25, 2016 by the Pension Bureau (the "Investments into LP by GPIF").

will be included into GPIF's business methods manual, etc.[5]

B. ALTERNATIVE INVESTMENTS BY GPIF

Currently, the type of assets that fall within "Alternative Assets" includes infrastructure, private equity, real estate and other asset types as determined by the Investment Advisory Committee of GPIF. GPIF commenced investments into Alternative Assets from 2014 in hopes that this type of investment would contribute to the diversification of GPIF's investment portfolio due to their different risk-return profiles from that of the traditional assets.[6]

However, in reality, since GPIF is prohibited from directly investing into shares (including those of unlisted corporation, etc.) as such investment may appear that GPIF is involved in management of an individual corporation, GPIF was investing into alternative assets through acquiring beneficiary units in investment trusts.[7] Where such investment trusts are further investing into LPs (or other investment vehicles), several issues have been pointed out, including the complexity of the structure involving many parties, potential that the management fees will be charged at two levels, risk management will be made only indirectly both at investment trust level and LP Fund level.[8] As of the end of December 2015, the balance of investments made by GPIF in Alternative Assets was only 0.04% of the total assets of GPIF.[9]

As a result of the foregoing, GPIF has been further developing its operational structure especially with respect to alternative investment expertise and risk management thereof. Furthermore, GPIF has stated its intention to increase the target of investments into Alternative Assets up to 5% of its total assets in the Phase 2 of the Mid-term Plan[10] expecting to promote reduction of relevant risks through diversification of portfolio and optimization of investment efficiency[11]. In this manner, GPIF is enabling itself to make direct investments into LP Funds as a new option for alternative investments.

C. PERMISSIBLE LP FUNDS

Based on a broad range of discussions, GPIF announced that its new policy will permit GPIF to make investments into a LP Fund subject to certain conditions. Specifically, GPIF will be prohibited from engaging in the following conducts[12]:

(i) make investment decisions with respect to the assets of the LP Fund;

(ii) seek to influence the decision making of the general partner; and

(iii) seek to exercise the voting rights of the shares, etc. of a portfolio company invested in by the LP Fund.

Furthermore, as the investment strategies of LP Fund may vary, it is expected that GPIF will only invest in LP Funds which meet and comply with the various conditions set forth below:[13]

(i) the target investments of the LP Fund are not be concentrated to specific shares;

(ii) the LP Fund shall not directly own real estates;

(iii) with respect an investment by the LP Fund into a portfolio company, GPIF's pro-rated holding in such portfolio company (via the LP Fund) shall not exceed 50% of the shares, etc. of such portfolio company;[14]

(iv) GPIF shall be required to make pre- and post-reporting to the Investment Advisory

5 Article 21, Paragraph 1, Item 1 of the Act on the Government Pension Investment Fund, Article 2, Paragraph 1 of the Enforcement Order, page 7 of the "Investment into LP by GPIF".

6 Page 2 of the "Investment into LP by GPIF".

7 Page 17 of the "About GPIF" and Note 3.

8 Page 6 of the "Investment into LP by GPIF".

9 Page 1 of the "Investment into LP by the GPIF". The composition of the assets as of the end of June 2016 are as follows: domestic bonds 39.16%, domestic shares 21.06%, foreign bonds 12.95%, foreign shares 21.31%, short-term assets 5.51% (the "investment results for the 1Q of fiscal year 2016").

10 Mid-term Plan is the document that sets forth the ratio of asset portfolio of long-term investments called the Basic Portfolio.

11 Page 1 of the "Investment into LP by GPIF", page 5 of the "Mid-term Plan of GPIF" approved for amendment dated October 31, 2014.

12 Pages 3 and 8 of the "Investment into LP by GPIF".

13 Pages 7 to 9 of the "Investment into LP by GPIF.

14 However, investments may be allowed after preliminary deliberation by the Investment Advisory Committee in certain cases where GPIF does not clearly have the dominant position in such individual investment (page 9 of the "Investment into LP by GPIF").

Committee of GPIF regarding its investment; and

(v) the LP Fund must be able to provide GPIF with any information which may be required by GPIF including the scope of the targeted investments, etc.

D. CONCLUSION

Investment managers of LP Funds are expected to be approaching GPIF through Type II Financial Instruments Dealer or through the relevant general partner (i.e. by filing of a notification for the Exemption for Special Business Activities Directed at Qualified Institutional Investors (the "**Article 63 Exemption**")) . However, details of the types of contemplated LP Funds which GPIF seek to invest or the relevant bidding procedure is still uncertain at this time.

As the recently amended Article 63 Exemption may apply to the general partner of any LP Fund which has Japan investors, where a LP Fund seeks a potential investment from GPIF, it is important that such LP Fund not only satisfy the requirements which may be specific to GPIF but also satisfy the requirements of the revised Article 63 Exemption.[15]

The Investment Management Group of DT Legal Japan has extensive experience in advising offshore investment managers with respect to the general rules of investments by Japan investors including GPIF and is happy to assist offshore investment managers assessing their capability of attracting investments from GPIF.

For anyone who did not receive this Client Alert and wishes to be placed on the mailing list for Japan regulatory updates issued by the Investment Management Group of DT Legal Japan or otherwise interested to receive past Client Alerts, please do not hesitate to contact us.

15 "Revisiting the Article 63 Exemption" – Japan Regulatory Update:April 14, 2016.
"Immediate Actions to be taken by August 31, 2016 - the Article 63 Exemption" - Japan Regulatory Update:July 7, 2016
"On-going Obligations for Article 63 Exemption Operators under the Amended Article 63 Exemption Regime" - Japan Regulatory Update:August 18, 2016

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