



# Japan Regulatory Update

Japan

DT Legal Japan

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## Revisiting the Article 63 Exemption

### A. BACKGROUND

Since the enactment of the Financial Instruments and Exchange Act of Japan (the “FIEA”) in 2007, the “Exemption for Special Business Activities Directed at Qualified Institutional Investors” (the “Article 63 Exemption”) has been frequently used by offshore fund managers to offer interests of their limited partnership funds to Japan investors. Given the relative ease by which general partners could register (i.e. file a Form 20 notification) under the Article 63 Exemption, the lack of burdensome ongoing reports and duties, and Japan investor requirements which were generally viewed as being easy to satisfy, the Article 63 Exemption was regularly relied on by offshore fund managers to market their investment funds in Japan without having to appoint a registered distributor.

However, after a series of amendments which imposed increasing obligations and duties on operators under the Article 63 Exemption (“Article 63 Exemption Operators”), the most recent amendments to the Article 63 Exemption promulgated by the Financial Services Agency of Japan (the “Japan FSA”) came into effect on March 1, 2016.

The March 1, 2016 amendments represent a drastic overhaul of the Article 63 Exemption regime by the Japan FSA. With the imposition of new rules with respect to business conduct (including investor suitability checks) as well as onerous reporting and disclosure obligations far greater than those required in the past, the Article 63 Exemption is no longer viewed as an “easy” Japan distribution model for offshore fund managers. In fact, given that all Article 63 Exemption Operators, even those that had filed prior to March 1, 2016, are subject to these new amendments<sup>1</sup>, many Article 63 Exemption Operators are seeking to deregister from this exemption.

In light of this background, the topic of this Client Alert will be to revisit the Japan regulatory analysis for existing Article 63 Exemption Operators – specifically, providing an overview of the analysis as to whether a current Article 63 Exemption Operator may deregister from the Article 63 Exemption.

### B. THE JAPAN REGULATORY ANALYSIS

In making a determination as to whether an Article 63 Exemption Operator, (typically, a general partner of a limited partnership fund,

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<sup>1</sup> Existing Article 63 Exemption Operators will be required to comply with the amended rules of the Article 63 Exemption in relation to ongoing obligations.

a “LP Fund”) must continue to rely on the Article 63 Exemption with respect to its Japan activities, a two-step test is necessary to determine whether:

- (1) the Article 63 Exemption Operator is engaging in “self-marketing” activities of its limited partnership interests directed at Japan investors; and
- (2) the Article 63 Exemption Operator is engaging in “self-management” activities with respect to any Japan limited partners.

If the answers to both of the above queries are “no”, then the Article 63 Exemption Operator does not need to rely on the Article 63 Exemption and may deregister from this exemption at any time.

### 1. Self-Marketing Activities.

If the Article 63 Exemption Operator itself is currently engaging in marketing activities directed at Japan investors with respect to the interests of the LP Fund, unless it is a registered Type 2 Financial Instruments Business Operator, it must operate under the Article 63 Exemption (i.e. self-marketing). It should be further noted that, any such self-marketing activities by the Article 63 Exemption Operator will be subject to various rules and regulations in Japan with respect to such marketing activities under the amended Article 63 Exemption.

There are certain common fact patterns where it is commonly held that an Article 63 Exemption Operator is not engaging in self-marketing activities. For example, if the Article 63 Exemption Operator has appointed a Type 2 Financial Instruments Business Operator as its Japan distributor and assuming that such distributor is appropriately involved in all marketing activities, it is commonly held that the Article 63 Exemption Operator is not engaging in self-marketing activities. Similarly, if the LP

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<sup>2</sup> A general partner could also seek to fully sub-delegate its investment management authority to a registered discretionary investment manager in Japan to avoid

Fund is closed for investment for new investors (i.e. no self-marketing activities is taking place), the Article 63 Exemption Operator should not need to rely on the Article 63 Exemption in relation to self-marketing activities.

Therefore, as the first step of this analysis, each Article 63 Exemption Operator should confirm if it is currently engaging in self-marketing activities. If the Article 63 Exemption Operator is not subject to satisfying the second test described below, it is possible that it may be able to deregister from the Article 63 Exemption.

### 2. Self-Management Activities.

As a matter of default, if there is a Japan limited partner directly invested in the LP Fund, the general partner of such LP Fund is deemed to be engaging in “self-management” activities with respect to such Japan limited partner – which would require that the general partner: (i) be registered as a discretionary investment manager with the Japan FSA; or (ii) rely on the exemption from self-management activities under the Article 63 Exemption. As it is highly unlikely that a general partner would seek (or be eligible) to be registered with the Japan FSA as a discretionary investment manager, most general partners are forced to rely on the Article 63 Exemption.<sup>2</sup>

However, under the FIEA, a general partner is not deemed to be engaging in “self-management” activities if it satisfies certain requirements as set forth under Article 16, Paragraph 1, Item 13 of the Cabinet Order concerning the Definitions specified in Article 2 of the FIEA (the “De Minimis Exemption”). Specifically, to rely on the De Minimis Exemption, the composition of the Japan investors of the relevant LP Fund must satisfy all of the following criteria:

- (1) all of the Japan limited partners of the

having to register itself but this option could have material tax consequences for the LP Fund.

- relevant LP Fund are Qualified Institutional Investors;
- (2) there are less than ten (10) Japan limited partners (including indirect Japan investors investing through Japanese limited partnerships) in the relevant LP Fund; and
  - (3) the total capital contributions made by the Japan limited partners are no more than 1/3 of the total capital contributions of the relevant LP Fund.

If the relevant LP Fund<sup>3</sup> satisfies all of the above requirements, the general partner is not deemed to be engaging in “self-management” activities and therefore does not need to operate under the Article 63 Exemption in relation to self-management activities.

### C. CONCLUSION

The recent amendments to the Article 63 Exemption provides a strong incentive for all Article 63 Exemption Operators to revisit their factual circumstances to determine whether they must continue to rely on the Article 63 Exemption.

It has been our experience that many Article 63 Exemption Operators that target institutional investors in Japan are able to satisfy both tests described above and therefore no longer need to operate under the Article 63 Exemption (i.e. may seek to withdraw their current registration).

However, due to the Japan investor composition requirements of the De Minimis Test, we are also aware that deregistration is often not possible for the general partners of LP Funds that are:

- (1) single investor funds;
- (2) Japan investor specific feeder funds or parallel funds; or

- (3) Japan employee or co-invest investment funds.

Notwithstanding the above, we recommend that all Article 63 Exemption Operators use this opportunity to engage in the above analysis to determine whether it is necessary for them to continue to operate under the Article 63 Exemption.

The Investment Management Group of DT Legal Japan has extensive experience in advising Article 63 Exemption Operators with respect to the application of the Article 63 Exemption and is happy to assist Article 63 Exemption Operators in applying the above determination as well as assisting Article 63 Exemption Operators in deregistering from the Article 63 Exemption.

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, please do not hesitate to contact us.

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<sup>3</sup> This determination is made on a fund by fund basis without any aggregation of feeder funds or parallel funds.

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