

# Opportunities for Fund Managers – Relaxed Licence Scheme

To strengthen the foundations of the capital markets and financial business in Japan, the Financial Instruments and Exchange Act ("**FIEA**") was amended<sup>1</sup> (the "**Amendment**") to, among other things: (a) consolidate the disclosure regulations for rights offerings, (b) expand the scope of disclosure permitted in English, (c) expand the scope of business in which banks can engage, (d) expand the scope of permitted borrowers of commitment line agreements, (e) introduce a relaxed registration scheme for qualified investors investment management business, and (f) introduce human resources requirements for investment advisory/agency businesses. In addition, fund managers must also pay attention to the related cabinet office ordinance which was amended to (g) introduce additional notification matters for the QII Special Exemption (as defined below) to accommodate the changes brought about by the Amendment.

This briefing note looks at the latter three changes which are closely related to the fund business - introduction of (i) the relaxed registration scheme for qualified investors investment management business, (ii) human resources requirements for investment advisory/agency businesses and (iii) additional reporting matters for the QII Special Exemption.

## Introduction of a Relaxed Registration Scheme for Qualified Investor Investment Management Business

This change encompasses two major amendments - the (i) relaxation of registration requirements; and (ii) relaxation of regulations for the offering of fund interests by fund managers.

### Key issues

- Introduction of a Relaxed Registration Scheme for Qualified Investor Investment Management Business
- Introduction of Human Resources Requirements for Investment Advisory/Agency Businesses
- Additional Notification Matters for QII Special Exemption
- General Overview

<sup>1</sup>

The Amendment was enacted by the Diet on 17 May 2011 and promulgated on 25 May 2011 and the related cabinet order and cabinet office ordinance were promulgated on 15 February 2012.

## Relaxation of Registration Requirements

Article 63 of FIEA already provides a licence exemption (the "**QII Special Exemption**") in respect of investment activities for qualified institutional investors ("**QII**"). The Amendment creates a new category of business - "qualified investors investment management business" ("**QI IMB**"), which still requires investment managers to be registered (licensed), but such registration requirements are relaxed in comparison to what is normally required for investment management business that falls outside the scope of the QII Special Exemption.

"QI IMB" is investment management business which is: (a) targeted at Qualified Investors (as defined below, *tekikaku-tohshika*) only; and (b) relates to funds with assets under management that total less than JPY 20 billion.

"Qualified Investors" include, among others:

- (i) "Specified Investors" (*tokutei tohshika*), for example - QIIs, the Government of Japan, the Bank of Japan, Japanese listed companies, Japanese joint stock companies (*kabushiki kaisha*, or KK) with a paid-in capital of JPY 500 million or more or expected to have such paid-in capital, special purpose companies (*tokutei mokuteki kaisha*, or TMK) and non-Japanese companies;
- (ii) employees' pension funds (*kousei nenkin kikin*) and corporate pension funds (*kigyō nenkin kikin*) which hold fund assets totalling JPY 10 billion or more;
- (iii) corporations which hold assets totalling JPY 300 million or more;
- (iv) corporations which hold assets totalling JPY 300 million or more as an operating partner (*gyōmu shikkō kumiai*in), etc.<sup>2</sup> ("**Operating Partner, etc.**");
- (v) individuals who hold assets totalling JPY 300 million or more as well as a securities or derivative account which has been maintained for more than one year after the account opening date;
- (vi) individuals who hold assets totalling JPY 300 million or more as an Operating Partner, etc.;
- (vii) officers of investment managers for QI IMB;
- (viii) employees falling under the categories specified by cabinet orders who are employed by investment managers for QI IMB; and
- (ix) parent companies of investment managers for QI IMB.

Hence, the QI IMB relaxed requirements cover a much broader group of investors than just QIIs (the subject of the QII Special Exemption). Further, the QI IMB relaxed requirements cover not only self-management business (*jiko-unyō-gyōmu*) but also discretionary investment management business (*tōshi-ichinin-gyōmu*). Table 1 below highlights major differences in coverage between the QII Special Exemption and the QI IMB relaxed registration requirements.

As a result, fund managers have the opportunity to enjoy a much broader relaxation with the new QI IMB relaxed registration scheme.

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<sup>2</sup> The role of the operating partner (*gyōmu shikkō kumiai*in) is similar to that of a "general partner" in a limited partnership. The operating partner is typically used in a case of a fund governed by Japanese law (such as a partnership (*nin'i kumiai*) a silent partnership (*tokumei kumiai*) or a limited liability partnership (*yuugen sekinin jigō kumiai*)).

**Table 1: Major Differences in coverage between the QII Special Exemption and the Qualified Investors Investment Management Business (QI IMB) relaxed registration requirements**

	QII Special Exemption	QI IMB
<b>Licence Requirements</b>	Notification	Registration
<b>Scope of Business Private Placements</b>	Self-solicitation concerning interests in collective investment schemes (Type 2 Securities)	Private Placement of Japanese/non-Japanese units of unit trusts and shares in investment corporations (Type 1 Securities under self-management)  Type 2 FIBO (as defined in section "Relaxation of Regulations concerning Offering of Fund Interests" below) registration is required
<b>Scope of Business Management</b>	Self-management business	Asset management business for investment companies  Business concerning discretionary investment management  Investment trust entrustment business  Self-management business  (The total amount of management assets is limited to JPY 20 billion or less)
<b>Scope of Investor</b>	One or more QIIs and 49 non-QIIs or less	Qualified Investors only
<b>Handling of a Fund of Funds</b>	Certain investment vehicles to be "looked through" (see below)	Certain investment vehicles to be "looked through" (see below)
<b>Code of Conduct</b>	Not applicable in principle Applicable as an exception	Applicable in principle Exempted under certain conditions

As with the QII Special Exemption, "a Fund of Funds" (e.g., TMKs or collective investment schemes such as a silent partnership (*tokumei kumiai*, or TK)) will be subject to a "look through" test, meaning that whether they fall within the definition of "Qualified Investor" will be determined depending on the nature of the end-investors investing in such investment vehicles.

In summary then, following implementation of the Amendment, the registration requirements for the structuring and offering of funds to Qualified Investors will be relaxed and hence, it will be easier to establish such investment management business than in the past. However, unlike the QII Special Exemption which only requires notification to the Financial Services Agency of Japan (the "FSA"), registration for QI IMB is necessary.

According to the materials thus far published by the FSA, the requirements which are expected to be relaxed for QI IMB are described in Table 2 below. Attention should be paid to the relaxed human resources requirements for QI IMB compared to the normal regulations (which are normally a focus of the FSA when examining registration applications) and have led to past applicants giving up on being registered because of the difficulty of satisfying the human resources requirements. The "Amended Comprehensive Guidelines for the Supervision of Financial Instruments Businesses" (the "**Amended Supervision Guidelines**") published on 15 February 2012 and came into effect on and from 1 April 2012 specify the following examination standards for the business structure of QI IMB applicants at the time of registration:

- Persons in charge of asset management for investors: one or more persons who have been engaged in advisory, management or other similar business for at least one year in respect of management assets of the same kind;
- Independent compliance department: the department has one or more members who have been engaged in giving guidance in respect of financial instruments business for compliance purposes or have similar experience (this compliance function can be outsourced); and
- Staff required for preparation and maintenance of books and records, segregated management of assets under management, system administration and other operational management: one or more staff who may be concurrently in charge of compliance.

Therefore, at least in theory and putting the other non-human resources requirements to the side, applicants could be eligible for a QI IMB registration if they have at least two persons on staff - one person with requisite experience in charge of asset management and one person with requisite experience in charge of compliance matters and maintenance of books and records. However, at the end of the day, the regulator will look at applicants on a case-by-case basis and make its decision upon taking into consideration the size of an applicant's business.

## Relaxation of Regulations concerning Offering of Fund Interests

The Amendment makes it possible for fund managers conducting QI IMB to offer interests in funds (which are Type 1 Securities) managed by themselves to Qualified Investors without being registered as a Type 1 financial instruments business operator (the "**Type 1 FIBO**"). Such business will be deemed Type 2 financial instruments business (the "**Type 2 FIB**") and fund managers will only be required to be registered as a Type 2 FIB operator (the "**Type 2 FIBO**") to conduct the same.

At present, and until the Amendment is implemented, investment managers who wish to handle private placements of Type 1 Securities as their business are, in principle, required to be registered as a Type 1 FIBO. After implementation of the Amendment, however, if the requirements (i) through (vi) provided below are satisfied, such investment managers are allowed to offer certain Type 1 Securities (provided in item (iii) below) with only a Type 2 FIBO registration. Please note that registration as an investment manager in respect of QI IMB alone does not allow a fund manager to handle private placements of Type 1 Securities - the manager must also be a registered Type 2 FIBO.

In order to qualify for the above relaxation, the fund manager must satisfy all of the following six requirements:

- (i) the fund manager must be registered as an investment manager for QI IMB;
- (ii) the fund manager must be authorised by its clients to conduct discretionary investment management business under a discretionary investment management agreement in respect of Type 1 Securities as set out in item (iii) below;
- (iii) the securities on offer must be certain Type 1 Securities under self-management such as units in Japanese/non-Japanese unit trusts or Japanese/non-Japanese investment securities (to be fully detailed in a cabinet ordinance);
- (iv) offers of the relevant securities are only made to Qualified Investors;
- (v) the person who has accepted an offer to purchase securities enters into an agreement restricting certain transfers by the time of entering into the acquisition agreement of such securities at the latest; and
- (vi) the fund manager deals with private placements of Type 1 Securities as set out in item (iii) above.

If the fund manager satisfies all the above six requirements and has a Type 2 FIBO registration, (which is easier to acquire than a Type 1 FIBO registration), it may deal with private placements of Type 1 Securities as set out in item (iii) above. In addition to the relaxed regulations for investment management business, this is expected to promote new fund managers entering the business.

Table 2: A comparison of the Normal Regulations and the Relaxed Regulations for QI IMB

	Normal Regulations	QI IMB Relaxed Regulations
<b>1. Registration Requirements</b>		
Human Resources Requirements	Strict and standardised requirements to ensure the proper conduct of business	The minimum number of required officer(s) and employee(s) is detailed in the Amended Supervision Guidelines
Capital and Net Asset Requirements	JPY 50 million or more	JPY 10 million or more
Requirements for KK	Company with a board of directors (i.e., three or more directors and one statutory auditor)	Company with a statutory auditor (i.e., one director and one statutory auditor)
Other	Compliance with regulations concerning violation records, eligibility of officers, side businesses and major shareholders restrictions are applicable	Same as normal regulations
<b>2. Offering of Fund Interests</b>		
Type of Licences required	In principle, a Type 1 FIBO registration is required  *A Type 2 FIBO registration is required for the offer of Type 2 Securities (such as limited partnership interests)	Certain Type 1 Securities can be offered with only a Type 2 FIBO registration

## Date of Implementation

Both the (i) introduction of QI IMB; and (ii) relaxations described in sections "Relaxation of Registration Requirements" and "Relaxation of Regulations concerning Offering of Fund Interests" above came into effect on 1 April 2012.

## Introduction of Human Resources Requirements for Investment Advisory/Agency Businesses

The Amendment introduces certain human resources requirements ("**Human Resources Requirements**") as one of the registration requirements for the conduct of investment advisory/agency business. Unlike introduction of the QI IMB as described above, the Amendment increases registration requirements rather than relaxes them.

## Background

Human Resources Requirements are already one of the registration requirements for the conduct of financial instruments exchange businesses other than investment advisory/agency business. Previously, there was no such registration requirement for investment advisory/agency business because these businesses were considered to be less risky than the other financial instruments exchange businesses, because the assets of customers were not dealt with directly by the investment advisors/agents. To date, the FSA has dealt with human resources issues of investment advisors/agents by issuing administrative orders.

However, recent investigations have revealed several cases of malicious violations of FIEA by investment advisors/agents (some investment advisors/agents were found to have no officers or employees with legal knowledge and experience of securities business). These cases have resulted in the introduction of Human Resources Requirements for investment advisory/agency business.

## Examination Standards of the Human Resources Requirements

The Human Resources Requirements are set out as "examination standards" in laws and regulations and the Amended Supervision Guidelines.

Once the Amendment comes into force, all new applicants for the registration of an investment advisory/agency business will be reviewed for compliance with the Human Resources Requirements and non-compliance with the requirements will be grounds for refusal of registration. For example, if there are insufficient officers/employees to properly conduct the business or where there is any officer or employee who is connected to antisocial forces then registration may be refused. Furthermore, since the FSA is entitled to take administrative measures, those who have already been registered as investment advisors/agents may be deregistered or have their business suspended for Human Resources Requirements shortcomings.

## Date of Implementation

The Amendment concerning the introduction of Human Resources Requirements for investment advisory/agency businesses came into effect on 1 April 2012.

## Additional Notification Matters for QII Special Exemption

The business operators conducting QII Special Exemption business (the "**Special Exemption Operators**") are allowed to manage partnership-type (*kumiai-gata*) funds and sell partnership interests of such funds by simply filing a notification to the FSA (i.e., without any registration) if they conduct such business with only clients consisting of (i) one or more QIIs and (ii) 49 or less non-professional investors, which is a major requirement. However, recently there have been cases where investors suffered damage from the fund managed by the notifying operator which had no QII as a committed investor or where a notification was filed by a corporation or entity which had no substance. As a result of that, the FSA has decided to strengthen the regulations for the Special Exemption Operators and added the following notification matters for the QII Special Exemption.

## Additional Notification Matters

The following specific notification matters and attached documents will be added to the current requirements:

For all new notifications for the QII Special Exemption, the operator shall, when filing:

- notify, with respect to each fund, the name of the investment business units (i.e., name of the fund) and the name of at least one QII so that the FSA can judge whether the operator satisfies the QII Special Exemption requirements; and
- attach documents with the notification verifying the operator's identity (a full commercial register for Japanese companies and a certificate of incorporation (no Japanese translation is required) issued by the relevant foreign authority for foreign companies).

If the operator has already filed a notification for the QII Special Exemption before 1 April 2012, such Special Exemption Operator shall no later than 30 June 2012:

- file a "Notification of the Name of the QII, etc." (the "**Amendment Notification**") stating the name of at least one QII and the name of the investment business units (i.e., name of the fund) with respect to each fund; and
- attach documents to the Amendment Notification verifying the Special Exemption Operator's identity (a full commercial register for Japanese companies and a certificate of incorporation (no Japanese translation is required) issued by the relevant foreign authority for foreign companies).

Please note that the additional obligation to notify the matters stated above will be applicable to all the existing Japanese and foreign funds.

## Date of Implementation

The Amendment concerning additional notification matters for the QII Special Exemption came into effect on 1 April 2012.

## General Overview

As stated above, the Amendment has relaxed the registration scheme for investment management business to promote smooth operation of fund business. On the other hand, the regulations for investment advisory/agency business and QII Special Exemption have been strengthened to a certain extent, and thus, fund managers need to pay more attention to compliance with FIEA.

*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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