CAPITAL MARKETS

JAPAN'S ARTICLE 63 EXEMPTION

Demystifying article 63

Investments made on behalf of qualified institutional investors have had a specific – and at times complex – regime since 2007

Since 2007, a large number of offshore fund managers have sought to raise capital in Japan by making self-offerings to, and conducting self-asset management activities for, Japanese investors in reliance on the exemption set forth in article 63 of the Financial Instruments and Exchange Act (FIEA). The exemption's scope and qualification requirements in both the distribution and asset management contexts need to be demystified.

Background of the article 63 exemption

A fundamental concept of the FIEA is that persons attempting to offer securities and/or manage assets for Japan resident investors as a business must be registered as a financial instruments business operator (FIBO) pursuant to article 29 of the FIEA. The article 63 exemption is an exemption from this business registration that is in principle required for self-offering and/or self-asset management activities with respect to domestic or offshore limited partnership (LP) etc that have Japanese investors.

Because of the burdensome requirements for maintaining a FIBO registration in Japan, including minimum capital requirements, costly personnel structures and complex operations, the article 63 exemption has been frequently utilised by offshore general partners (GPs), especially those that are special purpose companies without any staff.

Background of the exemption

Transition from SEA to FIEA

The regulatory framework for the article 63 exemption was introduced when the FIEA took effect on September 30 2007. Before the enactment of the FIEA, the former Securities Exchange Act (SEA) focused more on the regulation of liquid securities, including equity

1 MINUTE READ

The article 63 exemption is widely used to distribute interests in private equity funds to Japanese investors in a compliant matter. Article 63 files (general partners) are permitted to conduct self-offerings to, and self-asset management activities for, Japanese investors without obtaining a business registration.
Since its introduction in 2007, the exemption has been widely misunderstood. Amendments effective March 2016 drastically changed the regime, expanding filing requirements, obligations and prohibitions. This article attempts to demystify the article 63 regime by providing background on the history of the exemption, a summary of the requirements needed to be eligible to use the provision, and recent experience with the exemption.

securities and the brokerage businesses, and less on the self-offering and self-asset management activities for LP funds (that were not heavily regulated under the former SEA). Further, there was no distinction with respect to the degree of regulation depending on the specific attributes of investors.

In response to the need for comprehensive and cross-sectional rulemaking to reduce regulatory loopholes, the FIEA was enacted to enhance the integrity of the Japanese regulatory process and bring flexibility from the perspective of overall investor protection. Under the FIEA, securities companies, investment trust management companies, asset management companies and investment advisers that had been regulated under the previous vertically divided regulatory framework were merged into the concept of FIBOs under the same overall registration regime. The FIEA also introduced the concepts of professional investor and general investor, with the level of oversight and operational compliance depending on the type of investor from a perspective of the flexible protection of Japanese investors.

Introduction of the article 63 exemption

Because the new system of FIBO registrations is intended to apply even when target investors are highly professional institutional investors such as banks or asset management companies, there was a concern that the general rules would impede the activities of financial intermediaries. Thus, in order to ensure flexibility and operational efficiency, the concept of a category of qualified institutional investors (QIIs) was introduced and certain activities for QIIs came to be exempted from the registration principles.

Thus, the article 63 exemption was introduced as a regulatory regime for self-offering and self-asset management activities directly mainly at QII investors with respect to interests in collective investment schemes, schemes (an investment structure having securities investments from two or more investors, which undertakes investments using the capital raised and which distributes profits gained from the investment to investors).

Article 48 of supplementary provisions

At the time of the establishment of the FIEA, the government prepared transitional measures under article 48 of the FIEA. These supplementary provisions grandfathered existing funds even after the enactment of the FIEA. These rules allow business operators under the article 63 exemption to continue managing funds created prior to the enactment of article 63 until such funds are wound up. However, it did not allow article 63 exempted business operators to offer such funds to new investors on or after September 30 2007.

General rules of article 63 and the de minimis exemption

The article 63 exemption gives relief from both the self-offering restriction and the self-asset management restrictions noted above. Thus, an article 63 filer can select to be exempted from the distribution restrictions or the asset management restrictions, or both.

A GP that wishes to rely on the exemption for its activities is required to file a notification with the Kanto Local Finance Bureau (KLFB) on form 20. There is no limitation with respect to the number of LP funds that a single GP entity can offer and/or manage under the exemption. However, each LP fund must include at least one QII as an investor.

Where a GP (i) offers interests in an LP fund to non-QII Japan resident investors and/or (ii) manages an LP fund with non-QII Japan resident investors, the number of such non-QIIs must not exceed 49 investors and these limitations apply on a fund-by-fund basis. Consequently, there must already be at least one QII invested in the fund before any non-QII can invest.

In addition, the person involved in marketing the relevant LP fund must be an officer, director or employee of the entity that acts as an article 63 exempted business operator because the article 63 regime exempts only self-offering for the distribution side. Thus, employees of a manager that is not the GP of a fund cannot engage in solicitations made under the article 63 exemption unless they are also employed by the GP entity.

Employees of a manager that isn't the GP of a fund can't engage in solicitations made under article 63 exemption unless they are also employed by the GP entity

De minimis exemption

Another FIEA exemption critical to offshore GPs that are considering filing under the article 63 exemption is the so-called *de minimis* exemption. This exemption is limited and only available to an offshore GP of globally offered LP funds, which excludes the GP's self-asset management activities for Japanese Investors from the scope of the investment management business requiring registration where the offshore GP meets certain standards.

An offshore GP that seeks to rely on the *de minimis* exemption must ensure that it meets, and that it will meet as long as the GP holds assets of any Japanese investor, all of the following requirements:

(i) All of direct investors that have interests in the LP are QIIs, and all of indirect investors that have interests in the domestic collective investment scheme that owns the LP interest are QIIs.

(ii) The total of the number of direct investors and indirect investors is nine or fewer.

(iii) The total amount of money or other properties invested or contributed by direct investors does not exceed an amount equivalent to one third of the aggregate amount of money or other properties contributed from all of the limited partners of the LP fund including offshore investors.

If an offshore GP is able to ensure that the GP meets, and will continuously meet, all of the foregoing requirements, it can rely on the *de minimis* exemption for its self-asset management activities for Japanese investors. In these cases, the GP would only rely on the article 63 exemption for its self-offering activities.

Thus, if a GP is eligible under the *de minimis* exemption (on the asset management side) that GP can elect to withdraw from the article 63 exemption regime as soon as the GP has ceased to engage in self-offering for Japanese investors. Many foreign fund managers elect this approach to avoid the continuing reporting requirements under Article 63 noted below.

2016 amendments

Reasons for amendments

Due to the relatively simple procedure needed to prepare and submit form 20 with very little supplemental disclosure documentation prior to 2016, the article 63 exemption was very actively used by both domestic and foreign managers following its adoption in 2007 with several thousands of filings being made. In fact, some article 63 exempted business operators maintained their status even when maintaining such status was no longer required.

To make matters worse, individual investors having little financial knowledge (such as the elderly) were increasingly targeted because there was no limitation on the types of non-QIIs eligible to be solicited under the distribution side of the article 63 exemption with many resulting regulatory problems. Because of these abuses, and in order to better regulate offering activity under article 63, the exemption was significantly revised by an amendment to the FIEA that became effective on March 1 2016.

New form and deliverables

Form 20

The 2016 amendments drastically changed the documentation required to make and maintain an article 63 filing. Thus, a new form 20 was created under the 2016 amendments requiring considerably more information, including a brief description of the investment portfolio of each LP fund, and the name, type, and number of all prospective QIIs to be solicited. Offshore GPs were also required to appoint a representative in Japan, to serve as a contact person in Japan and to specify the name, address, and phone number of such representative in the form 20 filing.

Other deliverables

In addition to the new form 20, various additional deliverables are now required to complete an article 63 filing including, for example, an oath of the filer, an oath, resume and affidavit of each director (if the director is not a Japan resident), and for all officers and certain key employees of the article 63 filer together with a copy of the filer's constitutional document (memorandum of association or articles of incorporation) which previously had not been required.

Renewal filing of existing filers

As part of the 2016 amendments, all article 63 exempted business operators that filed prior to March 1 2016, the effective date of the 2016 amendment, were required to renew their filings by complying with all of the new filing requirements (unless they withdrew their status under the article 63 exemption on or before February 29 2016). As the new filing requirements were far more complicated than the existing ones, the government allowed a six-month grace period for these renewal filings as a transitional measure.

In light of the filing burdens and heavier obligations noted below, many offshore GPs conducted a careful factual analysis of their activities in Japan to determine if there was in fact any need to continuously rely on the exemption under the new regime. These firms examined whether the final closings of their LP funds were complete, whether their LP funds continued to hold assets of Japanese investors, and whether the GP was able to rely on the *de minimis* exemption in cases where the GP already ceased to offer interests in LP funds in Japan. As a result of this review, many offshore GPs decided to withdraw from the article 63 exemption regime and filed withdrawal notifications.

Expanded obligations

Annual reporting

Under the new regime following the 2016 amendments, each article 63 exempted business operator is required to annually prepare a business report with a balance sheet and income statement, and to file it with the KLFB within three months after the end of each fiscal year.

Disclosure

In addition, each article 63 exempted business operator is required to prepare a copy of form 20-2, and place and maintain a copy of this form in its principal business office, and in any other offices where business is conducted under the article 63 exemption, in order to make such information available to the public, or to post it on the internet, or disclose it by any other method to make it continuously and easily accessible to the public without delay after the initial filing. For these purposes, 'without delay' is in practice considered to be within one month.

Form 20-2 must be continuously disclosed throughout the term until the article 63 exempted business operator makes a withdrawal filing. The information for form 20-2 comprises a portion of the information in form 20, excluding information concerning prospective investors. Form 20-2 should be updated if any changes are made in form 20.

In addition, GPs are required to make a copy of form 21-3 available to the public in the same manner within four months of the end of each fiscal year. The GP must maintain the information disclosed for one year starting from the date that falls four months after the end of each fiscal year. The information for form 21-3 comprises a portion of the information in the annual business report.

Other books and records

GPs are also required to prepare books and records in addition to annual business reports and to retain them for certain minimum periods of time. In particular, all relevant transactional records and customer ledgers relating to the distribution activities, and all

Following the 2016 amendments, each article 63 exempted business operator is required to annually prepare a business report with a balance sheet and income statement

relevant investment management descriptions relating to its asset management activities, will need to be maintained for 10 years.

Limitation of non-QII eligible investors

After the 2016 amendments, the FIEA set a limit on the scope of non-QIIs that are eligible to invest in LP funds under the exemption to investors that are not QIIs but are comparatively sophisticated investors such as Japanese listed companies, foreign corporations, domestic corporations with JPY 50million ($450,300 approximately) or more of stated capital, and individual investors with JPY100 million or more of financial assets and who have held a securities account at a broker for more than a year. In addition, where the fund offered and/or managed assets under the article 63 exemption is considered a venture fund as defined in the FIEA, eligible non-QII investors can include persons who have experienced in starting up businesses etc.

However, as an additional protective provision, the amended article 63 requires that the aggregate amount of contributions (not capital commitments) from (i) experienced persons in the case of venture funds, and (ii) certain closely related persons that are in the relevant categories of eligible non-QIIs, must not be 50% or more of the aggregate amount of the total contributions of all Japanese investors. The 50% calculation is conducted on a fund-by-fund (and feeder fund) basis. If the calculation result is 50% or more, such GP's business under the article 63 exemption is prohibited as a business potentially detrimental to the protection of investors.

Other burdens of the amended article 63 that should be noted

With respect to prohibitions under article 63, it should be noted that self-offerings of interests in a LP fund must include constitutional documents (including the limited partnership agreement) that contain a provision requiring segregation of investor and manager (GP) monies. Foreign funds that cannot demonstrate asset segregation constitutionally or by contract may not be offered to investors in Japan.

Another result of the 2016 amendments that increases the risks for foreign managers under article 63 was the imposition of substantially greater penalties for non-compliance with the new article 63 regime, including an increase in the criminal penalty to five years of imprisonment, and a requirement for the suspension of the relevant exempted business where violations of Article 63 provisions occur.

Post-amendment experience and filing issues

Listing all prospective QIIs

In respect to prospective QIIs to be listed in form 20, the public comments of the Financial Services Agency of Japan (JFSA) explained that a filer needs to list at least one QII as a prospect at the time it submits a notification, and that it is no longer permitted to state 'undetermined' as was permitted before the 2016 amendments.

Because GPs may not solicit any Japanese investors until the article 63 filing is completed, the logical consequence is that GPs need to list one target QII's name even though that GP is not completely sure about the interest level of the relevant QII. On the other hand, if a GP markets to a QII that was not initially listed as a prospective QII, but becomes a prospective QII, the GP must file an amendment. The result has been that a GP operating under Article 63 now typically includes a list of as many QIIs as can reasonably identified in advance for solicitation so that no amendment will be required.

> **The Financial Services Agency of Japan explained that a filer needs to list at least one QII as a prospect at the time it submits a notification**

Closely related investors

Some offshore managers that wish to rely on the exemption for the placement of fund interests to their Japanese employees (to ensure alignment with the manager's objectives) should beware of the limitation of the contributions by closely related persons of an article 63 fund. Thus, certain employees that fall under the definition of closely related persons may be allowed to invest in LP funds under the Article 63 exemption. However, in these cases, the relevant LP fund must have at least one QII investor and receive 50% or more of the fund contributions from either QII(s), or other categories of eligible non-QIIs. Moreover, any GP of an LP fund that is found to not comply with this regulation (as reflected in its filed annual business reports) will be disqualified and potentially penalised.

Disclosure measures

With respect to the measures intended to make forms 20-2 and 21-3 available to the public, the JFSA has said in its response to public comments that offshore GPs that have no office in Japan must make such documents available to the public through the internet or any other method. It has also commented that while each GP is not required to create its own webpage, there is no specific guidance about what 'any other method' should be. On the other hand, the regulators appear to believe that it is critical to ensure that investors have access to the location where operators who in substance conduct their business under the article 63 exemption are present, and ensure that these individuals can properly respond to investors' inquiries. Because of this, a possible arrangement has been that the asset management company that manages the assets of the limited partnership based on the authority delegated by the GP, acts to hold form 20-2 (and make it available to the public), where applicable.

Notwithstanding the apparent flexibility with respect to the public notice requirement under article 63 expressed in public comments, the KLFB has recently repeatedly requested that offshore article 63 exempted business operators create a website and post forms 20-2 and 21-3 on the website (even though the KLFB thereafter will admit that there is no legal basis for this demand). In certain cases, offshore GPs may find it awkward to ignore the KLFB's requests in this regard because of other relationships with regulators in Japan. Because of this, if an offshore GP does not believe the information in its form 20-2, or its form 21-3, is particularly sensitive, it may elect to place it on a webpage for public review.

The foreign managers that still use article 63 manage very large funds with investments from Japan investors that expect strict compliance with local rules

Managing assets

Another area of continuing confusion is the question of when a manager is managing assets for Japanese investors. The FIEA provides no clear definition for this activity. Even if a GP merely holds assets contributed from Japanese Investors, such GP could be considered to manage assets under the FIEA and file and make annual reports under Article 63. This rule could apply even to management of nominal levels of assets (small holdings by Japanese investors). For example, even when the Japanese investor contributes assets in an operating company in exchange for an LP interest, or in circumstances where a LP fund in which Japanese Investors contributed assets is under liquidation procedures and assets in such a fund are already all in cash to be distributed, the regulators could take the position that these GPs are managing assets, requiring continuing article 63 compliance and complicating the liquidation process.

The future of article 63

After the 2016 amendments, certain regulatory burdens for article 63 exempted business operators are almost as heavy as those applicable to registered FIBOs. However, it takes much less time to complete a filing under the exemption compared to the registration process to become a FIBO. As offshore managers must complete either relevant FIBO registrations or make a filing under the article 63 exemption before marketing to, or managing assets of, Japanese investors, an article 63 filing is clearly more convenient where a fund closing involving Japanese Investors is anticipated in the near future.

It should also be noted that the current filing process under article 63 is in many ways similar to the process of submitting a FIBO registration application. In many cases, the regulator requires a very high level of formality for the filing documents by requesting consistency of wording among each of the filing documents. Also, in the Japanese regulatory process, the practice of refusing to provide a filing receipt stamp until all of the regulator's requests are satisfied exacerbates this problem. This regulatory approach can impose material additional costs (that were not originally expected) on the article 63 filer, which costs are eventually passed on to investors.

That said, many foreign managers (especially private equity managers) continue to rely on article 63 to support their distribution activities in Japan. In general, the foreign managers that continue to use article 63 tend now to be managers of very large funds that have very large investments by Japan investors that expect strict compliance with Japanese regulatory requirements. In these cases, the marginal cost of maintaining an article 63 filing is merely an investment in compliance and a means of ensuring that the large Japanese institutional investors remain investors in the flagship funds of these firms. This institutionalisation of the article 63 exemption appears to be what Japanese regulators intended in seeking the 2016 amendments and in this sense the re-regulation of article 63 (viewed 18 months' post-implementation) appears to have been a success.

Chiho Zen
Morgan, Lewis & Bockius (Tokyo)