June 30, 2020

FUNDS REGULATIONS IN JAPAN

A fund is an investment vehicle that (i) collects money (or other assets) from investors, (ii) invests the pooled money into securities, real estate, crypto, and other assets and (iii) distributes profits arising out of the investments to the investors. In Japan, there are three legal forms to set up a fund: (i) trusts, (ii) corporations, and (iii) partnerships. Mutual funds are structured as unit trusts under the Investment Trust and Investment Corporation Act (Law No. 198 of 1951, as amended), while J-REITs are corporations established under the same act. Funds structured as partnerships typically target a smaller number of investors and are generally more flexible in terms of investment, target investors, and timing of entry and exit than the other types.

In this article, we first outline the legal and regulatory environment for funds that invest primarily in securities and which are structured as partnerships. In the second part, we then take a closer look at crypto funds. Funds investing in real estate and commodities must comply with different laws and will be covered in a separate article.

1. Forms of Partnerships

Partnership-type funds under Japanese laws may be set up as (i) partnerships under the Civil Code (Law No. 89 of 1896, as amended), (ii) silent partnerships under the Commercial Code (Law No. 48 of 1899, as amended), (iii) limited partnerships for investment under the Limited Partnership Act for Investment (Law No. 90 of 1998, as amended), and (iv) limited liability partnerships under the Limited Liability Partnership Act (Law No. 40 of 2005, as amended).

Depending on the percentage of foreign investors[1] and the percentage of investments in foreign assets[2], foreign partnership-type funds such as limited partnerships in the Cayman Islands may be more suitable. This topic will, however, be covered in a separate article.

The characteristic features of each legal form will be outlined in the following.

1.1. Partnerships under the Civil Code

According to Article 667(1) of the Civil Code, a partnership is established when each of the parties promises to make a contribution and to engage in a joint undertaking. When using a partnership under the Civil Code as a fund, the partners are jointly responsible for the day-to-day operations of the fund by the act, though the partners typically delegate the management of the fund to one or more partners.

For funds set up as partnerships under the Civil Code, there are no investment restrictions. All

[1] This may affect the application of pass-through taxation.

[2] There are restrictions on investments in foreign securities for Limited Partnerships for Investments as discussed in more detail below.

partners assume unlimited liability and, in general, all profits and losses are distributed to the partners depending on their overall contributions.

1.2. Silent Partnership (*Tokumei Kumiai Partnership*)

A silent partnership is a contract between a business operator and an investor according to Article 535 of the Commercial Code.

The operator of a silent partnership carries out the business under his/her own name and on his/her own account. The silent partner does not play an active role and is only obliged to make contributions. In turn, he/she is entitled to participate in the profits generated by the business of the operator. The liability of a silent partner is stipulated in a silent partnership agreement and is usually limited to the amount of his/her contribution.

Under the applicable laws there are no investment restrictions for silent partnerships.

Since a silent partnership agreement is a two-party agreement, an operator concludes individual contracts with each investor.

1.3. Limited Partnership for Investment (LPS)

A limited partnership for investment is a partnership under the Limited Partnership Act for Investment[3] and consists of partners with a limited liability, limited partners (**LP**), and at least one general partner (**GP**) with an unlimited liability. For funds structured as a LPS, a GP is responsible for operating the fund's business, while LPs are not involved in the day-to-day operations of the fund. A LP's liability is limited to the amount of his/her contribution.[4]

LPS are subject to investment restrictions.[5] A LPS must, for example, not invest more than 50 percent of its total funds in foreign securities.[6]

1.4. Limited Liability Partnership (LLP)

A limited liability partnership is a partnership under the Limited Liability Partnership Act (**LLP Act**)[7]. The personal liability of all partners is limited to the amount of their contributions.[8] A LLP is generally managed jointly by all partners. While it is possible to delegate day-to-day operations to a single partner, important decisions must be made jointly by all partners of the LLP. Entering into an agreement concerning the disposition or acquisition of material assets or borrowing of large amounts of money are matters requiring the consent of all partners.[9]

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[3] Article 2(2) of the Limited Partnership Act for Investment.
[4] Article 7(1), 9(1) and (2) of the Limited Partnership Act for Investment.
[5] Article 3(1) of the Limited Partnership Act for Investment.
[6] Article 9 of the Enforcement Order of the Limited Partnership Act for Investment.
[7] Article 2 of the LLP Act.
[8] Article 15 of the LLP Act.
[9] Article 12 of the LLP Act.

Though there are no investment restrictions for LLPs, LLPs are not used as investment vehicles very often. One of the main use cases for LLPs as investment funds is the establishment of a movie production committee.

TABLE 1: SUMMARY OF PARTNERSHIP-TYPE FUNDS IN JAPAN

	Partnerships under the Civil Code	Silent Partnerships	Investment LPS	LLP
Partners	general partners	an operator and a silent partner	general partner(s) and limited partners	limited partners
Agreement	agreement between all partners	one-to-one agreement between operator and silent partner	agreement between all partners	agreement between all partners
Registration	n/a	n/a	necessary	necessary
Ownership of Assets	partnership	operator	Investment LPS	LLP
Day-to-day operation of the fund	jointly by all partners (delegation to single partners or third parties possible)	operator	general partner	jointly by all partners (delegation to single partners or third parties possible to a certain degree)
Investment restrictions	n/a	n/a	investments limited to those assets listed in Article 3(1) of the LPS Act for Investment (e.g. shares, certain types of bonds, and investments in silent partnerships)	no investment restrictions

			restrictions ≤ 50 percent of total funds in foreign securities, and no investment in crypto assets	

2. Partnership Interests as Interests in a Collective Investment Scheme

The Financial Instruments and Exchange Act (FIEA) treats certain partnership interests, namely interests in so-called "collective investment schemes", as securities. The definition of collective investment schemes under the FIEA is as follows:

(1) the interests in the fund constitute rights based on a partnership agreement under the Civil Code, a silent partnership agreement, an investment LPS agreement or an LLP agreement

(2) the partnership uses the collected funds for its business, i.e. investments; and

(3) the investors are entitled to receive dividends or to participate in the profits arising out of the business conducted by the partnership or the distribution of assets by the partnership.

Activities involving collective investment schemes are subject to disclosure and registration requirements as well as conduct controls. The solicitation of interests in a collective investment scheme to investors is considered a solicitation of securities. The management of a fund's assets is an investment management business under the FIEA. Both must be registered with the Financial Services Agency (FSA)[10].

3. Regulatory Requirements

3.1. Disclosure Requirements

The public offering or secondary distribution of highly liquid securities such as shares, or bonds (type I securities) is generally subject to disclosure requirements and must be

[10] Even if all of the requirements from (1) to (3) are fulfilled, there are certain cases where the interests are not considered securities. These are cases (i) where all of the fund's business is carried out with the consent of all investors, and where (ii-a) all of the investors regularly engage in the invested business, or where (ii-b) the investors participate in the invested business using their specialized skills which are indispensable for the continuation of the business (Article 2(2)(v)(*i*) of the FIEA, Article 1-3-2 of the FIEA Enforcement Order).

registered with the FSA.[11]

The disclosure requirements for the offering or distribution of less liquid securities such as interests in a partnership type fund (type II securities) are less strict under the FIEA.[12]

3.2. Regulations for Businesses Primarily Engaging in Sales

The public offering or private placement of interests in a collective investment scheme[13] may only be carried out by registered Type II Financial Instrument Business Operators (Type II FIBO).[14]

This also applies to the self-offering of partnership interests to Japanese investors by a GP or a partner with similar authorities if the fund is a collective investment scheme as explained above.

To get registered as a Type II FIBO a person must fulfill certain criteria. This includes among others meeting minimum capital requirements and hiring fit and proper personnel (e.g. a compliance officer with eligible knowledge and experience) for operating the business. Only where an applicant meets all requirements stipulated in the FIEA and subsidiary legislation the FSA must approve an application for registration.

3.3. Regulations on Investment Management

With respect to funds the term investment management business is understood as the management of money or other property invested by a person connected with investments primarily in securities or derivatives which are based on investment decisions requiring the valuation and analysis of such instruments.[15] In this context, "primarily" means that generally more than 50% of the assets under management are invested in securities or derivatives. To conduct an investment management business a company must register as an Investment Management Business Operator.[16] Similar to Type II FIBO persons engaging in the investment management business must meet certain criteria, including minimum capital requirements and hire fit and proper personnel. Only where an applicant meets all requirements, the FSA must register an applicant as Investment

[11] Article 4(1) of the FIEA.

[12] If a fund's interests fall under the definition of "securities investment business rights" or "electronic record transfer rights", they are subject to disclosure regulations (Article 3(iii)(*i*)-(*ha*) of the FIEA). The term "securities investment business rights" generally covers cases where more than 50% of a fund's contributions are invested in securities. In that case, the full disclosure requirements apply if the number of persons acquiring fund interests exceeds 500 (Article 2(3)(iii) of the FIEA, Article 1-7-2 of the FIEA Enforcement Order). For further details on electronic record transfer rights (i.e. tokenized interests in a fund), see Section 4.3 below.

[13] As discussed in Section 2 above, interests in a collective investment scheme are deemed securities according to Article 2(2)(v) or (vi) of the FIEA.

[14] Article 28(2)(i) and Article 2(8)(vii) of the FIEA.

[15] Article 2(8)(xv)(*ha*) and Article 28(4) of the FIEA.

[16] Article 29 of the FIEA.

Management Business Operator.[17]

3.4. Entrustment of Sales and Investment Management to Third Parties

The registration requirements in Section 3.2 and 3.3 above do not apply to the fund if the fund entrusts all sales and investment management activities to another party which is registered as a Type II FIBO and/or Investment Management Business Operator with the FSA.

3.4.1. Public Offerings and Private Placements by Third Parties

When a partnership-type fund entrusts all "external" activities concerning its public offering or private placement to a registered Type II FIBO, the GP of the fund does not have to register as a Type II FIBO.[18]

3.4.2. Investment Management by Third Parties

When a partnership-type fund delegates certain activities completely to a registered Investment Management Business Operator, the GP of the fund does not have to register as an Investment Management Business Operator. In order for the exemption to apply, the fund must comply with the requirements set out in Article 1-8-6(1)(iv) of the FIEA Enforcement Order and Article 16(1)(x) of the Cabinet Office Order on Definitions under Article 2 of the FIEA.

The main requirements are as follows:

(i) The (silent) partnership agreement must include a provision considering the delegation of the investment management to a third party, the name of the investment management company registered as Investment Management Business Operator, and summary of the discretionary investment management agreement with and remuneration of the investment manager.

(ii) The agreement with the investment manager must include provisions on the duty of care and loyalty, the prohibition of self-trading, and the investment manager's remuneration.

(iii) The fund must segregate its assets from its investors' assets and the investment manager must confirm this.

(iv) The investment manager of the fund must give prior notice to Financial Local Bureau (a delegate of the FSA).

[17] FSA's Public comment Response No. 190, etc. (2007.7.31).
[18] FSA's Public Comment Response No. 103, etc. (2007.7.31).

3.5. Specially Permitted Businesses for Qualified Institutional Investor

Exemptions to the registration requirements outlined in Section 3.2 and 3.3 above may apply, under the exemption as a Specially Permitted Business for Qualified Institutional Investors (QII), etc. (QII Exemption also known as Article 63 exemption). Many funds that target QIIs and other sophisticated investors make use of this exemption.

To fall under the QII exemption a fund must solicit (i) one or more QII, and (ii) less than 49 qualified investors other than QII. None of the investors must fall under the category of non-qualified institutional investors.[19][20]

Persons who conduct business under the QII Exemption are not obliged to register as Type II FIBO or Investment Management Business Operator but have to submit a comparably simple notification to the FSA. The notification must include certain information about the fund (type of the fund), the GP (or a partner with an equivalent authority) and the investing QII(s). Foreign GPs must appoint Japanese representatives for the notification. Persons filing the notification are subject to additional requirements, including conduct controls almost equivalent to registered Type II FIBO or Investment Management Business Operators. Furthermore, a fund making use of such notification is subject to ongoing disclosure requirements for each fiscal year.

For your information, the QII Exemption requirements were tightened in 2015, mainly due to an increase of losses caused by malicious actors. Before the 2015 amendments, a fund was able to solicit retail investors. Now, the scope is limited to qualified investors. Qualified investors are investors who have a certain level of knowledge and experience in investments and include listed companies, corporations with capital of JPY 50 million or more, and individuals having more than JPY 100 million investment-type financial products as assets and more than one year investment experience.

The definition of qualified investors was however considered to be too narrow for investments in venture funds[21]. For venture funds the definition of qualified investors was therefore broadened and additionally includes (former) officers of listed companies as well as specialists (e.g. certified public accountants, lawyers).[22]

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[19] Article 63(1) of the FIEA, Article 235 of the Cabinet Office Order on Financial Instruments Business.

[20] Persons listed under Article 17-12(1) of the FIEA Enforcement Order and Article 233-2 of the Cabinet Office Order on Financial Instruments Business.

[21] A venture fund means a fund which invests more than 80% of its assets in shares of non-listed companies and satisfies the other requirements in Article 17-12(2) of the FIEA Enforcement Order, Article 233-4 and 239-2(1) of the Cabinet Office Order on Financial Instruments Business.

[22] Article 17-12(2) of the FIEA Enforcement Order, Article 233-3 of the Cabinet Office Order on Financial Instruments Business.

TABLE 2: INVESTORS OTHER THAN QII UNDER THE QII EXEMPTION

Prior to the 2015 revision		Since the 2015 revision	
All partnership-type funds	Anyone	Ordinary partnership-type funds	Listed companies, corporations with capital of 50 million yen or more, individuals having more than JPY 100 million assets and more than 1 year investing experience after opening their securities accounts.
		Venture funds	In addition to the above, officers of listed companies, persons who have been officers of listed companies within the past five years, and specialists.

TABLE 3: BUSINESS REGISTRATION AND NOTIFICATION REQUIEMENTS UNDER THE FIEA FOR THE SALES AND MANAGEMENT OF FUNDS

	General registration requirements	Registration requirements in case of complete entrustment to a registered third party	Availability of the QII exemption
SALES			
Sales by issuer itself	Type II FIBO registration	n/a (for the third party, Type II FIBO registration)	yes, but Article 63 FIEA notification
Sales by third party (on behalf of the issuers)	Type II FIBO registration	n/a if sales activities are sub-delegated to a registered third party (rarely the case)	Type II FIBO registration (QII exemption does not apply)
INVESTMENT MANAGEMENT			
Management of funds that invest +50% in securities by GP	registration of GP as Investment Management Business Operator	n/a (for the third party, Investment Management Business operator registration	yes, but Article 63 FIEA notification
Management of funds that invest +50% in securities by third party	third party must register as Investment Management Business Operator	n/a if management activities are sub-delegated to a registered third party (rarely the case)	third party must register as Investment Management Business Operator Registration (QII exemption does not apply)
Management of other funds (incl. crypto funds)	n/a	n/a	n/a

4. Regulations on crypto asset funds

A crypto fund can be understood as (i) a fund that primarily invests in crypto assets, (ii) a fund that collects crypto assets from its investors, or (iii) a fund that is tokenized. In the following, we will outline the applicable regulations in more detail and discuss the impact of the latest revision of the FIEA on tokenized investment funds.

4.1. Funds Investing in Crypto Assets

4.1.1. FIBO Registration

Funds investing in crypto assets are subject to the same rules and regulations as other partnership-type investment funds. In case of self-solicitation, operators of the fund must therefore generally register as Type II FIBO.[23] Exemptions from the registration requirement apply for the solicitation of QII, etc.[24] Also, if a fund delegates its sales activities to a registered Type II FIBO, the fund operator must not register as a FIBO itself.

4.1.2. Investment Management Registration

The operator of an investment fund that mainly invests in securities and derivatives must generally register as Investment Management Business Operator. Since crypto assets are neither considered securities nor derivatives under the FIEA this does not apply for funds operators that mainly invest in crypto assets. Please note, however, that security tokens constitute securities under the FIEA. Investing in security tokens may therefore trigger registration requirements provided that certain thresholds are passed (≥ 50 percent of the total investments into security tokens).

4.1.3. Funds Investing in Crypto Assets and Crypto Exchange Registration

It is sometimes argued that a fund investing into crypto must register as a crypto asset exchange service provider under the Payment Services Act (PSA). However, it is unlikely that registration is necessary considering the fact that a registration is only required if the trading is carried out as a "business". Where the trading is carried for investment purposes, the requirements stipulated by the FSA for a "business" are not met.

4.2. Investment Funds Raising Crypto

The definition of funds requires among others the collection of money. Before the 2020 revision of the FIEA, crypto assets were not considered money within the meaning of the FIEA. This has changed with the new laws entering into force on May 1, 2020. Under the new laws crypto assets are deemed money within certain provisions of the FIEA[25], including the

[23] Article 28(2)(i) and Article 2(8)(vii) of the FIEA.
[24] Article 63 of the FIEA.
[25] Article 2-2 of the FIEA and Article 1-23 of the FIEA Enforcement Order.

provisions on collective investment schemes. The raising of crypto assets is therefore covered by the FIEA.

4.3. Tokenized Interests

With the 2020 revision of the FIEA the concept of electronically recorded transfer rights (**ERTR**) were introduced. Article 2(3) of the FIEA defines ERTR as follows:

> "Electronic Recorded Transfer Right" are rights that fulfill all requirements from (1) to (3) and do not fall under (4):
>
> (1) Rights listed in Article 2(2) of the FIEA (funds, beneficial interest in a trust, membership rights of general partnership company, etc.)
> (2) which are recorded electronically, and
> (3) may be transferred by using an electronic data processing system.
>
> (4) Cases specified by Cabinet Office Ordinance taking into account the liquidity constraints and other circumstances.

Interests in a fund which are tokenized are generally considered ERTR. Given their (potentially) increased liquidity they are subject to the same regulations as more liquid type I securities. Third parties engaging in the sale of tokenized interests must therefore register as Type I FIBO.[26] The self-solicitation of tokenized interests by a fund is subject to the same registration requirements as the self-solicitation of funds in general. A fund must therefore register as a Type II FIBO and, if ≥50% of the money is invested in securities or derivatives, as an Investment Management Business Operator, unless an exemption applies. The QII exemption and the exemption in case of entrustment of all sales and investment activities to third parties also apply to tokenized funds.[27]

Since ERTR are generally subject to the same regulations as type I securities disclosure requirements apply. An issuer of ERTR is therefore obliged to prepare a prospectus[28] and to register the offering with the FSA[29]. In addition to the initial disclosure, ongoing disclosure

[26] Article 28(1), Article 2(8) and Article 2(9) of the FIEA.

[27] In order to use the QII exemption for the self-offering of ERTR, ERTR must satisfy the following requirements in addition to the requirements which apply to non-tokenized fund, Article 63(1)(i) of the FIEA and Article 234-2(1)(iii) of the Cabinet Office Order on Financial Instruments Business. For **ERTR which are sold to QII:** Technical measures have been taken to prevent the transfer of the ERTR to persons other than QII. For **ERTR which are sold to specified investors other than QII:** Technical measures have been taken to prevent the transfer of ERTR to QII or specified investors other than QII and such transfer shall be made in bulks.

[28] Article 13(1) and Article 15(1) of the FIEA.

[29] Article 4(1) of the FIEA.

requirements apply.[30] Something different only applies in the case of private placements. These are placements with QII, professional investors or a small number of investors (≤ 50 investors) only.

For more detailed information on security token offerings (**STOs**), please click here.

TABLE 4: BUSINESS REGISTRATION AND NOTIFICATION REQUIREMENTS UNDER THE FIEA FOR THE SALE AND MANAGEMENT OF TOKENIZED FUNDS

	General registration requirements	Registration requirements in case of complete entrustment to a registered third party	Availability of the QII exemption
SALES			
Sales by issuer itself	Type II FIBO registration	n/a (for the third party, Type II FIBO registration)	yes, but Article 63 FIEA notification
Sales by third party (on behalf of the issuers)	Type I FIBO registration *	n/a if sales activities are sub-delegated to a registered third party (rarely the case)	no, Type I FIBO registration necessary *
INVESTMENT MANAGEMENT			
Management of funds investing primarily in crypto assets by GP or third party	n/a	n/a	n/a
Management of funds that invest +50% in security tokens by GP	registration of GP as Investment Management Business Operator	n/a (for the third party, Investment Management Business Operator registration	yes, but Article 63 FIEA notification
Management of funds that invest +50% in security tokens by third party	third party must register as Investment Management Business Operator (**)	n/a if management activities are sub-delegated to a registered third party (rarely the case)	no, registration as Investment Management Business Operator necessary

* These are differences from table 3 for non-tokenized funds. In case of non-tokenized funds, a type II FIBO registration is required.

[30] Article 24 of the FIEA.

TABLE 5: DISCLOSURE REGULATION

Type of solicitation		Investors	Obligation to disclose
Private placement	Private placement with QII only*	QII only	generally not applicable
	Private placement to a small number of investors*	≤49 investors	
	Private placement to specified investors*	specified investors only	
Public offerings		unlimited number of investors	securities registration statement ** (continuing disclosure of semi-annual reports, extraordinary reports, etc.)

* Technical measures must have been taken to restrict resale.

** When the total issue price is less than JPY 100 million the obligation to file a securities registration statement does not apply (Article 4(1)(v) of the FIEA).

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