

STRUCTURED FINANCE BULLETIN

February 2016

Reform of the Article 63 Exemption under the FIEL - from a real estate fund practice perspective -

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| I. The Reform taking effect | Mori Hamada & Matsumoto |
| II. Contemplated structure in this note | Eriko Ozawa |
| III. Stricter requirements to qualify for the QII-targeted Fund Exemption | +81 3 5220 1816
eriko.ozawa@mhmjapan.com |
| IV. New rules on filings and disclosure | |
| V. Restrictions and impositions on the conduct of business | |
| VI. Record-keeping and reporting obligations | |
| VII. Enhanced supervision and enforcement | |
| VIII. Roadmaps for existing funds | |
| IX. Impact of the Reform | |

I. The Reform taking effect

On March 1, 2016, the reform (the “**Reform**”) on collective investment schemes using the QII¹-targeted fund business exemption (the “**QII-targeted Fund Exemption**”) will take effect. The QII-targeted Fund Exemption is a widely-used exemption for real estate private funds using the “GK-TK structure” in Japan, under Article 63 of the Financial Instruments and Exchange Law of Japan (the “**FIEL**”)².

During the course of the Reform, on February 3, 2016, the Financial Service Agency (the “**FSA**”) released its replies³ (the “**FSA Replies**”) to the public comments submitted to the FSA on the draft amendments to the relevant FIEL Cabinet Order, Cabinet Office Ordinances and Guideline that were posted on November 20, 2015.

¹ “QII” is an abbreviation of a “Qualified Institutional Investor” under the FIEL.

² In this note, all references to the FIEL, the FIEL Cabinet Order, and the FIEL Cabinet Office Ordinances and the relevant Guideline are references to the amended versions thereof, unless otherwise specifically mentioned.

³ The FSA Replies (in Japanese) are available on the FSA website:
<http://www.fsa.go.jp/news/27/20160203-1.html>.

STRUCTURED FINANCE BULLETIN

The last page of this note contains a snapshot of the Reform. Broadly speaking, this Reform:

- ✓ limits the scope of investors permitted to invest in funds invoking the QII-targeted Fund Exemption;
- ✓ imposes additional requirements to qualify for the QII-targeted Fund Exemption;
- ✓ increased the necessary items and documents for the notification to avail of the QII-targeted Fund Exemption;
- ✓ requires certain disclosures regarding the business of QII-targeted Fund Operators;
- ✓ imposes further restrictions and impositions on the conduct of the business of QII-targeted Fund Operators; and
- ✓ enhances the powers of governmental agencies regulating QII-targeted Fund Operators.

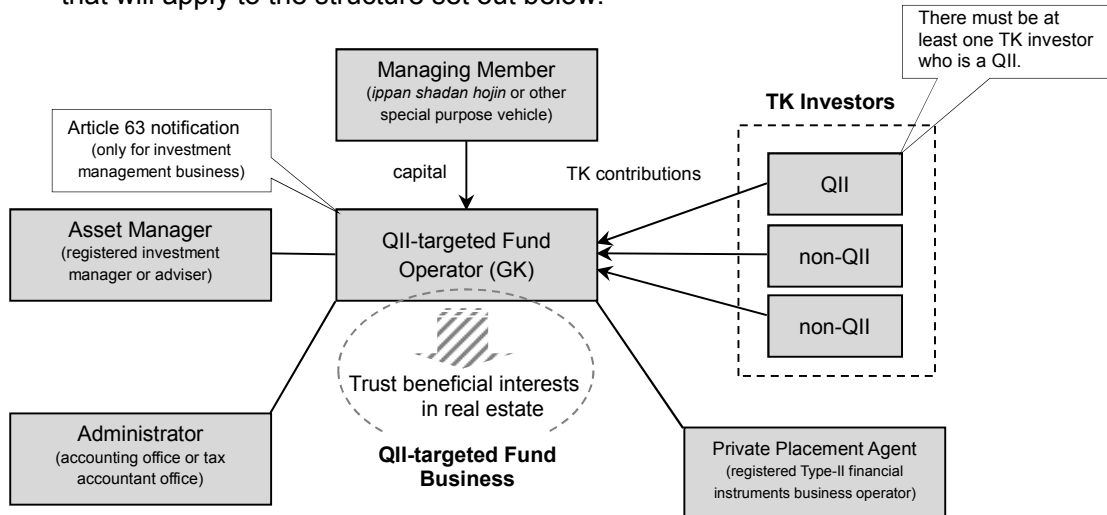
This note sets out key points for industry players in the Japanese real estate fund practice, and provides a roadmap for existing funds to go through the Reform.

II. Contemplated structure in this note

Under the current practice, private real estate funds often use a GK-TK structure, where the fund takes the form of a GK (*godo kaisha*) and the GK manages the cash contributions of the TK investors by investing such contributions in trust beneficial interests in real estate. As long as the GK's business qualifies for the QII-targeted Fund Exemption, the GK, as the operator of such business (such operator, a "**QII-targeted Fund Operator**" and such business, "**QII-targeted Fund Business**") is allowed to operate an investment management business, just by filing a simple notification with the relevant local financial bureau, without being subjected to any registration requirement.

STRUCTURED FINANCE BULLETIN

To highlight the relevant key points for a vast majority of QII-targeted Fund Operators in the context of real estate funds, this note focuses on the points that will apply to the structure set out below:



This note assumes that:

- ✓ the GK will invoke the QII-targeted Fund Exemption for purposes of conducting an investment management business, but not for the private placement of TK contributions;
- ✓ the GK will not use the so-called “venture fund exemption” under Article 17-12, Paragraph 2 of the FIEL; and
- ✓ none of the TK investors will use the venture fund exemption.

III. Stricter requirements to qualify for the QII-targeted Fund Exemption

1. The scope of “non-QII” investors that can invest in QII-targeted Fund Operators will be limited

The current FIEL does not limit the scope of non-QII investors that can invest in QII-targeted Fund Operators as long as the number of non-QII investors in one QII-targeted Fund Business does not exceed 49. After the Reform, however, the scope of non-QII investors that may invest in a QII-targeted Fund Business will be limited to the persons or entities listed in **Chart 1** below (a “**Permitted Non-QII**”).

The non-QII investor must be a Permitted Non-QII at the time the private placement was offered to that person.

STRUCTURED FINANCE BULLETIN

Please refer to III.2.

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| <ul style="list-style-type: none"> a. The Japanese government b. The Bank of Japan c. Local governments d. Financial instruments business operators registered under the FIEL and registered financial institutions, and their subsidiaries and affiliates e. Persons conducting a private placement or investment management business for collective investment schemes (“Collective Investment Scheme Operators”) f. Officers or employees of Collective Investment Scheme Operators g. Parent companies of Collective Investment Scheme Operators, or <u>subsidiaries, or subsidiaries of the parents, of Collective Investment Scheme Operators</u> h. <u>Persons entrusted with managing authority by Collective Investment Scheme Operators (including subcontractors⁴)</u> i. <u>Advisers to Collective Investment Scheme Operators (regardless of whether it has direct privity of contract with the Collective Investment Scheme Operator⁵)</u> j. <u>Officers or employees of the persons described in item g., h. or i. above</u> k. <u>Spouses and close relatives of Collective Investment Scheme Operators or the persons described in item f., h., i. or j. above</u> l. Publicly listed companies, and their subsidiaries and affiliates m. Corporations capitalized at JPY 50 million or more, and their subsidiaries and affiliates n. Corporations having net assets of JPY 50 million or more, and their subsidiaries and affiliates o. Special corporations established under special laws | <ul style="list-style-type: none"> p. <i>Tokutei Mokuteki Kaisha</i> or TMK q. Corporate Pension Funds whose assets are expected to be JPY 10 billion or more r. Foreign corporations s. Individuals whose assets are expected to be JPY 100 million or more, and who have held a brokerage account for one year or more t. Individuals holding assets expected to be JPY 100 million or more in his capacity as managing partner u. Public Interest Incorporated Associations or Foundations aimed for regional or industrial development, 25% of whose voting rights is held or 25% of whose contributions is made by the Japanese government or local governments v. Existing Employees’ Pension Funds whose assets are expected to be JPY 10 billion or more w. Foreign corporate pension funds or employees’ pension funds whose assets are expected to be JPY 10 billion or more x. Corporations whose assets are expected to be JPY 100 million or more y. Corporations holding assets expected to be JPY 100 million or more in its capacity as managing partner z. Companies managing assets for an individual described in item s. or t. above (subject to further requirements) aa. Issuers of interests in foreign collective investment schemes (subject to further requirements) bb. Companies managing assets whose management income is estimated to constitute 75% or more of gross income (subject to further requirements) |
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⁴ The FSA Replies, No. 38

⁵ The FSA Replies, No. 42

STRUCTURED FINANCE BULLETIN

2. New requirements regarding investor composition (the “Investor Composition Requirement”)

After the Reform, the QII-targeted Fund Exemption will not be available if:

- all the QII TK investors are Japanese Investment Business Limited Partnerships (*toshi jigyo yugen sekinin kumiai*) and none of these partnerships have assets under management (minus borrowings) that are estimated to be at least JPY 500 million; or
- 50% or more of the total TK contributions is funded by the persons who fall under any categories g. to k. in Chart 1 (except a QII, a person who falls under any category in Chart 1 (except categories f. through k.), and officers, employees and parent companies of the QII-targeted Fund Operator).

3. Disqualified persons

After the Reform, certain persons will be disqualified from invoking the QII-targeted Fund Exemption. Among others, a foreign corporation which has not appointed a Japanese resident as a representative in Japan cannot become a QII-targeted Fund Operator.

IV. New rules on filings and disclosure

1. Additional information and accompanying documents for new notification form

The information to be provided by a QII-targeted Fund Operator in the notification to be filed with the relevant authority (the “**Form 20 Notification**”) now includes the outline of the business⁶ and the names and the number of all the TK investors that are QIIs.

An amendment notification must be filed with respect to any change in the information set out in a Form 20 Notification.

⁶ According to FSA Reply No. 288 and the sample entries in the Form 20 Notification, an outline of the fundamental investment policy and strategy, such as the type and location of primary investment target properties (e.g., commercial facilities, office buildings, residential properties, hotels or logistics facilities) must be set out in the Form 20 Notification.

STRUCTURED FINANCE BULLETIN

Supporting documents or certificates must be filed to prove that the QII-targeted Fund Business fulfills the Investor Composition Requirement.

2. The authority will publicly disclose certain portions of the Form 20 Notification

Within one year and six months starting March 1, 2016, the authority will commence the public disclosure of certain information in the Form 20 Notification.

Among others, the outline of the business and the number of TK investors that are QIIs will be publicly disclosed. The names of the TK investors will not be disclosed.

3. Each QII-targeted Fund Operator must make certain portions of the Form 20 Notification available to the public promptly upon the filing

Promptly after the filing of a Form 20 Notification, each QII-targeted Fund Operator must make available to the public certain information set out in the Form 20 Notification through public inspection or the Internet. The scope of the information to be disclosed to the public is the same as the scope of information to be disclosed by the authority (See 2. above).

Unlike the disclosure to be made by the authority, there is no grace period for complying with this requirement.

V. Restrictions and impositions on the conduct of business

Under the current FIEL regime, QII-targeted Fund Operators are subject to only two restrictions on the conduct of business. However, after the Reform, QII-targeted Fund Operators will be subject to certain restrictions and impositions on the conduct of its business as listed below, which will be similar to those imposed on financial instruments business operators registered under the FIEL.

STRUCTURED FINANCE BULLETIN

Restrictions that were applicable to QII-targeted Fund Operators even prior to the Reform:

- ✓ prohibition on false explanation
- ✓ prohibition on compensation for losses

Restrictions that will be applicable to QII-targeted Fund Operators after the Reform:

- ✓ duty of good faith to customers
- ✓ prohibition on name-lending
- ✓ prohibition on providing investors with conclusive evaluations
- ✓ prohibition on certain activities defined in the Cabinet Office Ordinance
- ✓ prohibition on certain business operation
- ✓ prohibition on transactions where separate management of contributed funds is not secured
- ✓ prohibition on offerings where money is misappropriated
- ✓ fiduciary duty and duty of care of a good manager
- ✓ prohibition on transactions that would harm investors' interests
- ✓ obligation to manage the fund's assets separately from other assets
- ✓ restrictions on advertising*
- ✓ delivery of documents prior to or upon execution of contracts*
- ✓ principles of suitability*
- ✓ delivery of an investment management report*

* The items with asterisks will not apply to QII-targeted Fund Operators in relation to TK investors that are sophisticated investors (*i.e.*, specified investors (*tokutei toshika*) under the FIEL).

Given that these restrictions are now applicable to QII-targeted Fund Operators, they will be also subject to a broad range of provisions in the reformed Guideline, such as those requiring each Fund Operator to have an adequate system to procure a proper level of internal controls. Typically, however, it is not realistic for a QII-targeted Fund Operator in a GK-TK structure to procure such internal controls because it is usually a special purpose vehicle without any human resources. In this respect, FSA Reply No. 507 clarified that the reformed Guideline recognizes that certain QII-targeted Fund Operators are special purpose vehicles with an independent director but no employees, and engage the services of competent investment advisers or managers and administrators (in a nutshell, these QII-targeted Fund Operators function similarly as a *Tokutei Mokuteki Kaisha* or TMK).

STRUCTURED FINANCE BULLETIN

VI. Record-keeping and reporting obligations

1. Record-keeping obligation

The Reform will require QII-targeted Fund Operators to prepare and keep certain books and records. Such book-keeping obligations are similar to those applicable to registered investment managers.

FSA Replies No. 405 to 407 clarify that QII-targeted Fund Operators are allowed to outsource book-keeping work to a third party .

2. Obligation to submit an annual business report

The Reform will also require QII-targeted Fund Operators to prepare and submit a business report for each fiscal year within three months after the end of the fiscal year.

3. Obligation to make an explanatory booklet available to the public

After the Reform, QII-targeted Fund Operators must prepare an explanatory booklet (which is effectively an excerpt of the annual business report) for each fiscal year and make it available to the public, through public inspection or the Internet, for one year starting on the day after the four-month period that follows the end of the fiscal year.

4. Additional items requiring notification

The Reform will expand the list of items requiring notification. Among others, if there is any change in the articles of incorporation of a QII-targeted Fund Operator or it becomes subject to a lawsuit or mediation, this information must be reported to the authority through a notification.

VII. Enhanced supervision and enforcement

The Reform will broadly enhance the power of the regulators to supervise, and take enforcement measures over, QII-targeted Fund Operators. In particular, note that:

STRUCTURED FINANCE BULLETIN

- Not only QII-targeted Fund Operators, but also its business partners could be subject to the reporting requirements or on-site inspection; and
- QII-targeted Fund Operators could be subject to a business improvement order or business suspension order.

VIII. Roadmaps for existing funds

The Reform provides for certain transitional measures for existing QII-targeted Fund Operators. Based on such transitional measures, the roadmap to comply with the Reform is outlined below:

<p>Prior to or upon the Reform taking effect on March 1, 2016</p>	<p>Basic principle:</p> <p>Each existing QII-targeted Fund Operator can continue its on-going QII-targeted Fund Business, unless it starts soliciting offers to make additional TK contributions on or after March 1, 2016.</p>
	<p>To comply with stricter restrictions and impositions on the conduct of its business (See V. above):</p> <ul style="list-style-type: none"> ✓ Make sure that the Fund Operator has engaged a proper asset manager and administrator and the scope of their work is sufficient to comply with those restrictions and impositions; ✓ Look out for those restrictions and impositions at all times going forward. In this regard, confirm if the TK investors are sophisticated investors (specified investors under the FIEL) and, if yes, some impositions may not apply; and ✓ Check what steps the Fund Operator should take in order to treat the TK investors as sophisticated investors.
	<p>To comply with the record-keeping and reporting obligations (See VI.1. above):</p> <ul style="list-style-type: none"> ✓ Make sure that the scope of work by the asset manager or administrator covers the necessary record-keeping and reporting services.
	<p>From the fiscal year starting on or after March 1, 2016 and thereafter (See VI.2. and VI.3. above):</p> <ul style="list-style-type: none"> ✓ Prepare and submit an annual business report; and ✓ Prepare and make available to the public an explanatory booklet.
	<p>If there is any change in the articles of incorporation, or any other notification event arises (See VI.4. above):</p> <ul style="list-style-type: none"> ✓ File a notification of the change.

STRUCTURED FINANCE BULLETIN

Within 6 months starting March 1, 2016	File a new Form 20 Notification setting out all additional information, together with the required accompanying documents (See IV.1. above).
	Then, promptly after filing the new Form 20 Notification, make available to the public certain information set out in the Form 20 Notification.
If the Fund Operator starts soliciting additional TK contributions on or after March 1, 2016	<p>Make sure that (See III. above):</p> <ul style="list-style-type: none"> ✓ All target investors will be either a QII or Permitted Non-QII; ✓ There will be at least one QII TK investor that is not a Japanese Investment Business Partnership with assets under management below the minimum requirement; and ✓ The TK contributions funded by certain closely-related non-QII investors should not constitute 50% or more of the total TK contributions.

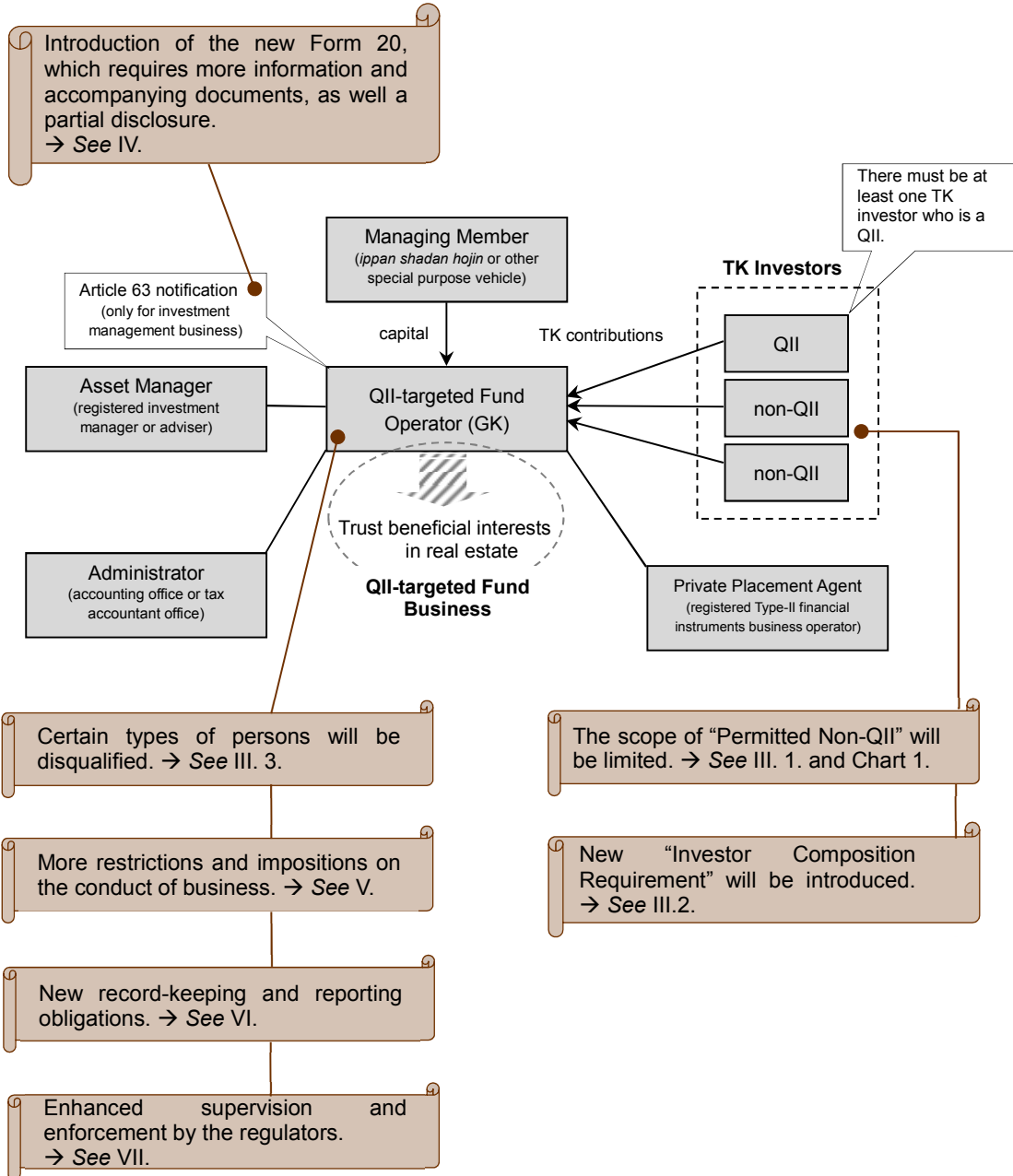
IX. Impact of the Reform

It is true that the Reform will make it more difficult and complicated to implement the QII-targeted Fund Exemption. However, considering the current real estate fund practice, it should be rare for the Reform to impose critical impediments to setting up or maintaining a GK-TK structure using the QII-targeted Fund Exemption. We expect that most players will become accustomed to complying with the new requirements for the exemption in a fairly short period of time.

On the other hand, given that the compliance with the QII-targeted Fund Exemption will be an added burden, some players may reconsider using a GK-TK structure or a TMK structure by weighing various factors inherent to each structure.

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Snapshot of the Reform



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- **Firm selected as a shortlisted law firm in the category of "Japan (Domestic law advisers)" in Chambers Asia-Pacific Awards 2016**
- Mori Hamada & Matsumoto was selected as a shortlisted law firms in the category of "Japan (Domestic law advisers)" in Chambers Asia-Pacific Awards 2016.

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➤ **Opening of MHM Jakarta Desk**

We are pleased to announce the opening of an MHM Desk in Jakarta, Indonesia. The MHM Jakarta Desk will operate in the offices of Arfidea Kadri Sahetapy-Engel Tisnadisastra ("AKSET Law"), and MHM lawyers stationed in their office will work together with AKSET Law to provide legal services for Indonesia-related transactions.

AKSET Law is a prominent Indonesian law firm with 30 lawyers (including two foreign lawyers) established in 2010. In a relatively short period of time, the firm and its lawyers have become highly regarded by Asian Legal Business, Asian-MENA Counsel, Asialaw Profiles, and in other industry rankings from 2013 to 2015. AKSET Law has a wealth of experience providing legal services concerning general legal matters in Indonesia, including investments and projects in Indonesia by Japanese and other overseas companies. More information regarding AKSET Law may be found in <http://aksetlaw.com/>.

➤ **Additional pages released in simplified Chinese**

We have added pages in simplified Chinese to our website.

➤ **Top ranking received in "Who's Who Legal: Banking 2016"**

Toru Ishiguro, Masanori Sato and Yuto Matsumura were selected as the leading lawyers in Japan in "Who's Who Legal: Banking 2016."

➤ **Firm ranked 1st in Japan Capital Markets Review for Legal Advisors 2015 by Thomson Reuters**

Mori Hamada & Matsumoto was ranked 1st in the Japan Capital Markets Review for Legal Advisors in 2015 by Thomson Reuters in the ranking of legal advisors for manager of common stocks in Japan.

➤ **26 new lawyers joined Mori Hamada & Matsumoto**

26 lawyers who qualified in December 2015 joined Mori Hamada & Matsumoto.

(Contacts)
Public Relations
mhm_info@mhmjapan.com
+81-3-6212-8330
www.mhmjapan.com