

---

# New Regulatory Framework for Units of Non-regulated Collective Investment Schemes in Japan

*Hiroyuki Kansaku\**

## I. Introduction

Collective investment schemes (CIS), including hedge funds and private equity funds that are not strictly regulated by special laws and regulations for CIS (hereinafter “non-regulated CIS”), are at the center of international debate as to how they should be regulated. According to the reports of the International Organization of Securities Commissions (IOSCO)<sup>1)</sup> and Financial Stability Forum (FSF), there is over US\$1.6 trillion in hedge fund assets under management worldwide and the number of funds has steadily grown to more than 9000,<sup>2)</sup> the vast majority managed in the USA and the United Kingdom.<sup>3)</sup> Hedge funds are not legally defined in any country, and are characterized by high management fees and a number of different complex and active strategies aiming for a high yield. They are frequently structured in such a way as to avoid or minimize regulation. They are therefore usually exempt from direct regulation and are not constrained by regulatory capital requirements and

---

\* Professor of Law, University of Tokyo.

1) IOSCO is an international policy forum consisting of 109 securities regulators as of the end of February, 2008.

2) Financial Stability Forum, Update of the FSF Report on Highly Leveraged Institutions, May 19, 2007. In 2006 it is estimated that 1,518 new funds were introduced and 717 liquidated. The rate of growth of hedge fund management has been more rapid in Europe and Asia than in the United States. The share of hedge fund assets managed in Asia has risen from 5% in 2002 to 8% in 2006, while the share managed in Europe has doubled, to 24%, over the same period. While assets managed in the US have grown sharply in absolute terms, the US share of the global total has correspondingly declined, from more than 80% in 2002 to about 65% in 2006.

3) Technical Committee of the International Organization of Securities Commissions, The Regulatory Environment for Hedge Funds: A Survey and Comparison, Nov. 2006.

public disclosure requirements.<sup>4)</sup>

The 1997-1998 Asian financial crisis was possibly caused by the huge short sale of hedge funds. This indicates that the activities of large hedge funds might impact significantly on financial markets and international financial systems. Furthermore the collapse of one hedge fund could threaten the integrity of financial markets and increase systemic risk worldwide, as the case of the Long-Term Capital Management crisis demonstrated.<sup>5)</sup> At present, hedge funds again appear to be closely involved in the so-called sub-prime loan problem. Using hedge funds, a number of financial institutions have invested in asset-backed securities. The underlying assets of these securities are mortgage loans to borrowers who do not qualify for the best market interest rates because of their relatively inferior creditworthiness. The European Central Bank, Federal Reserve Board and Bank of Japan have adopted measures such as injecting cash into the money market to address liquidity shortage at commercial banks.

On the other hand there is a sort of non-regulated CIS in Japan which invests in a particular business engaged in by the scheme or member of the scheme. The units of such non-regulated CIS are sometimes distributed not only to professional investors but also to the public, and might result in huge financial loss to them. The scheme itself might be fraudulent and deceitful, because the business plan invested in by the fund is entirely fictitious or very faulty from the beginning.<sup>6)</sup>

This article focuses on collective investment schemes that are not regulated by special laws and regulations, covering a broad spectrum from hedge and private equity funds to fraudulent schemes. In Japan, the activities and behavior of such non-regulated CIS have garnered great attention. At one end of the spectrum there are some non-regulated CIS that are equivalent to fraud. At the opposite end of the spectrum there are hedge and private equity funds that make full use of advanced

---

4) Financial Stability Forum, Report of the Working Group on Highly Leveraged Institutions, Apr. 5, 2000, at § 20-33.

5) According to the survey by the Japanese Financial Agency, the number of financial Institutions investing in hedge funds is 348, and the amount invested therein was 7,438 billion yen as of March 31, 2006. 348 financial institutions were investing in hedge funds, totaling 7.4 trillion yen as of March 31, 2006, Japanese Financial Services Agency, Hedge Fund Survey Results (2006) [*Hedge Fund Chosa no Kekka* (2006)], Mar. 2007, at 4.

6) In recent years the World Ocean Firm that solicited for investment in shrimp farming business and Heisei-den-den that solicited for investment in leasing business in the form of an undisclosed partnership based upon the Japanese Commercial Code are notorious cases where many investors suffered financial loss.

financial technology. Hedge and private equity funds play a remarkable role in recent M&A transactions and the restructuring process of corrupt firms in Japan. However, some of them have little transparency and might involve violation of laws and regulations, such as insider dealing and manipulation. These cases have provoked a wide-ranging discussion in Japan, whether and how the non-regulated CIS should be regulated.

In 2006, the Japanese Securities and Exchange Law of 1948 was completely amended and even the name of the law was changed to the Japanese Financial Instruments and Exchange Law (hereinafter called “JFIEL”). JFIEL came into force on September 30, 2007. It established the general definition of a collective investment scheme, to cover any unit of CIS comprehensively as a “security” under the law. Article 2 Paragraph 2 No. 5 of JFIEL states that a unit of a CIS is to be deemed as “security,” when the scheme (a) collects money or similar properties from two or more persons, (b) conducts business using the money contributed, and (c) distributes profits or properties originating from the business to investors.<sup>7)</sup> A unit of non-regulated CIS that should be deemed as a “security” falls into a category of second-class “security.” Therefore, a person who engages in fund related business (for example, offering and distributing the units of a non-regulated CIS) is in principle to be registered with the Japanese Financial Services Agency and to be subject to the regulations under JFIEL.

This article proceeds as follows: Part II will survey the status of various types of collective investment schemes that are not regulated by special laws and regulations in Japan. The typical legal structure of non-regulated CIS such as hedge funds and private equity funds will be introduced, especially the legal form of the fund itself and the legal position of investors in the scheme. Part III describes and analyzes some recent cases in which non-regulated CIS took an active role in the battle for corporate control. Part IV describes a new regulatory framework for units of non-regulated CIS under the Japanese Financial Instruments and Exchange Law of 2006. Each unit of a non-regulated CIS is deemed a second-class “security” under the law. JFIEL requires registration for any party that engages in self-offering of the units of non-regulated CIS or self-investment-management of assets contributed from

---

7) JFIEL, Article 2, Paragraph 2, No. 5. A unit of collective investment scheme in foreign countries should be also included under the definition of security under the law. *See* JFIEL, Article 2, Paragraph 2, No. 6.

investors. Private offerings to one or more qualified institutional investors or less than 50 ordinary investors are required to be filed with the Japanese Financial Services Agency. Part V notes the framework for international cooperation of authorities for supervising securities markets; namely multilateral memorandum of understanding concerning consultation and cooperation and the exchange of information (MOU) in IOSCO. The Japanese Financial Services Agency became signatory of the IOSCO MOU this February. Part VI is a conclusion.

## **II. Status, Functions and Risks of Non-regulated CIS in Japan**

### *1. Status of Non-regulated CIS*

In Japan, there are two categories of collective investment schemes (CIS): strictly regulated CIS and non-regulated CIS. Strictly regulated CIS should be subject to special laws, regulations and administrative rules which regulate arrangement of the scheme, the structure and organization of the vehicle, business conduct of obligations of related parties, etc. Most important are the Law of Investment Trust and Investment Corporation and the Law concerning Asset-backed Securities, Real Estate Syndication Law and the Law concerning the Regulation of Commodity Investment.

On the other hand, the extent of non-regulated CIS is not clear. There was no legal definition of non-regulated CIS, including hedge funds and private equity funds, under the former Japanese Securities Instruments and Exchange Law. According to research by the Japanese Financial Services Agency, non-regulated CIS in Japan consist namely of hedge funds, activism funds, private equity funds, venture capital funds, restructuring funds, REIT (Real Estate Investment Trusts) and others that invest directly in a particular business (Table 1). Examples of this last type might be investing in business of making film (contents fund), and in leasing business for telecommunication facilities, or running a chain of Chinese noodle restaurants (fund for business). In Japan, the number of venture capital funds is 470, and the total number of buy-out funds and restructuring funds is fifty-seven.<sup>8)</sup> The total assets

---

8) Material No. 1-4 for the meeting of the 1<sup>st</sup> Subcommittee of the Sectional Committee on Financial System in Financial System Council in the Financial Services Agency of Japan on Nov. 24, 2005.

**Table 1. Non-regulated Investment Funds in Japan**

	Legal form of funds	Main investor	Total and number of funds
Hedge fund	Limited partnership and trust established in foreign countries	Institutional investors Business companies	N.A.
REIT	Stock Company Undisclosed partnership	Institutional investors	4.2 trillion yen
Contents fund	Limited partnership, Partnership Undisclosed partnership Trust	Related business parties Individual investors	N.A.
Fund for business	Undisclosed partnership	Individual investors	N.A.
Venture capital fund	Limited partnership, Partnership Undisclosed partnership	Institutional investor Individual	1.3 trillion yen 420 funds
Buy-out fund	Limited partnership, Partnership Undisclosed partnership	Institutional investor	1.1 trillion yen 57 funds
Restructuring fund	Limited partnership, Partnership Undisclosed partnership	N.A.	N.A.
Regional restructuring fund	Limited partnership, Partnership Undisclosed partnership	Local financial institutions Local government	190 billion yen

under the management of Japanese venture funds and buy-out funds are about 2.3 trillion yen. The data about hedge funds is not available because many involving business in Japan are registered in offshore financial centers such as the Cayman Islands.<sup>9)</sup>

## 2. Typical Legal Forms and Structures

The non-regulated CIS in Japan could take a number of legal forms and structures. Civil law partnership (*Minpô-kumiai*), undisclosed partnership (*Tokumei-kumiai*) based upon the Japanese Commercial Code, and for-profit or non-profit corporation or trust are usually taken as legal forms for non-regulated CIS.

When a non-regulated CIS does not invest in securities but engages in business by itself (business-type CIS), it usually takes the form of civil law partnership or

<sup>9)</sup> It is possible in Japan for a strictly-regulated CIS to take active strategies with leverage. The number of such privately placed hedge funds is 231 and assets under their management amount to about 800 billion yen. IOSCO, *supra* note 3, at 20.

undisclosed partnership based on the Japanese Commercial Code. In these cases a general partner (as in the case of a civil law partnership) or a firm (with whom undisclosed partners conclude an undisclosed partnership contract in the case of an undisclosed partnership), engages in a particular business by using assets contributed by investors.

The non-regulated CIS whose assets are managed by investment managers (investment-type CIS) normally takes a legal form of corporation or trust. The fund is required to protect its assets from the bankruptcy of the related parties, such as the fund manager (so-called bankruptcy remote) or other funds invested by the same manager. Therefore, the asset of the fund is to be separated from the investment managers and is held by a special purpose vehicle (SPV) for the scheme. This is the reason why corporation and trust are normally used as a SPV.

The structure of a hedge or private equity fund is complex. Although the fund governing body has its own investment portfolio, investments could be allocated across the funds invested by the same investment manager. The portfolios require to be rebalanced when investors enter or exit individual funds. To avoid the reallocation and rebalancing, a Master-Feeder structure is generally used. The portfolio is held and traded at the level of the master fund, and the returns of the master fund will be reflected in the net asset value of the feeder funds.

A master fund is often structured as a corporation or a trust, often in offshore financial centers aiming for tax-exemption, and its feeder funds are established as the undisclosed partnership based on the Japanese Commercial Code. The assets of CIS established in offshore centers are invested by the fund manager. The fund's investment management agreement might contain the investment restrictions, investment policies, and fees to be paid to the manager. The manager delegates the investment powers to an investment manager and monitors the investment manager as a service provider. The fund manager may also distribute the units of the CIS under the investment management agreements or an additional separate distribution agreement.

### *3. Functions and Risks*

The functions and roles of non-regulated CIS are generally accepted. They provide investors with opportunities aiming at high return. They contribute furthermore to the efficiency of capital markets and the market for corporate control.

There are several examples where corrupt firms were acquired by an investment fund and their shareholder value increased dramatically through M&A transactions and/or restructuring. This is often considered an important indicator of the quality of corporate governance. After Japan's bubble economy burst in the 1990s, many financial institutions and businesses either went bankrupt or were forced to reorganize. International hedge funds and private equity funds acquired the shares of some corrupt companies and tried to reorganize them. Some have been successfully reorganized and their shares are again traded on the stock exchange.

On the other hand, the business-type CIS have sometimes caused many investor protection problems in Japan. Recently, the units of non-regulated CIS, which engaged in the leasing business or shrimp farming business, were distributed to the public, and many non-professional investors suffered huge financial loss. The units represented the position of an undisclosed partner in undisclosed partnership contract based on the Japanese Commercial Code. The units were sold to the public without applying securities laws and regulations because the legal position of the undisclosed partner at that time was not deemed as "security" under the former Japanese Securities and Exchange Law, unless the purpose of the undisclosed partnership was to invest in securities. These cases brought to light that there were crucial loopholes in the former Japanese securities laws and regulations from the viewpoint of investor protection.

Moreover, for some non-regulated CIS that use highly developed financial technologies, often together with borrowing, it is recognized that there is little transparency and this might involve violation of laws and regulations, such as insider dealing and manipulation. I introduce some cases in Part III, where investment funds played great role in the struggle for corporate control and caused heated disputes and legal issues.

### **III. Recent Cases in Japan**

#### *1. Background*

Since 1960, there have been several fights for corporate control or hostile takeovers in Japan. In most of these cases, it was pointed out that green-mailers had aimed to sell shares back to the target company at a substantial premium above the

fair market price. Target companies defended the fight for control by issuing new shares to the main bank or interested parties such as group member companies. This was done in order to decrease the shares owned by the aggressors.

Japanese corporate law states that the issuance of shares or the sale of treasury shares should be ceased in cases where the law or the articles of incorporation is violated, or in instances where such share issue or disposition of treasury shares is effected by using a method which is extremely unfair, if shareholders are likely to suffer disadvantage.<sup>10)</sup> Those intending to acquire the target company often took legal action to demand cessation of the issuance of shares to the particular third party. The courts have adopted “main purpose tests,” whether the issuance aims mainly to retain incumbents’ control or to raise funds to develop business. The courts have relatively easily recognized that the main purpose of issuing shares was fund-raising rather than retaining incumbents’ control. The majority of Japanese corporate lawyers and scholars support the case-law because successful hostile takeovers by green-mailers would decrease or ruin the value of the target company.<sup>11)</sup>

Since the 1990s, however, international and domestic investment funds and publicly-held corporations have begun to attempt hostile takeovers. Some of the target companies intend to retain control over incumbent management by issuing shares or distributing share options to the main bank or companies belonging to the same group of companies. However, in these cases, it is likely that the court would decide that the main purpose of issuance of shares was retaining incumbents’ control. A number of Japanese publicly-held corporations have therefore begun to adopt defensive measures to prevent hostile takeovers such as so-called poison pills or rights plan in advance. Some non-regulated CIS are actively involved in such battles for corporate control. Clearly, there are several risks associated with such behavior.

## 2. *The Livedoor and Murakami Fund cases*

Fuji Television Network, Inc. was originally a subsidiary of Nippon Broadcasting System, Inc. However, the total shareholder value of Fuji Television Network was

---

10) Japanese Company Law, Article 210 in the case of issuance of shares and Article 247 in the case of issuance of offered share options.

11) KENJIRO EGASHIRA, LAWS OF STOCK CORPORATIONS [*Kabusiki Kaisha Ho*], 691-93 (2nd ed., 2007) (available only in Japanese).

higher than that of Nippon Broadcasting System. In order to correct the reversed parent-subsidiary company relationship,<sup>12)</sup> Fuji Television Network intended to acquire all shares of Nippon Broadcasting System in accordance with the tender offer system under the Japanese former Securities and Exchange Law. During that time, the Murakami Fund and Livedoor were acquiring Nippon Broadcasting System shares both on the stock exchange and outside of the stock exchange. The Murakami Fund was founded and managed by Yoshiaki Murakami, a former Japanese Ministry of Economy, Trade and Industry bureaucrat. Mr. Horie, a founder, CEO and major shareholder of Livedoor, decided informally to acquire control of Nippon Broadcasting System and consequently control of Fuji Television Network. Livedoor established several investment funds and through them secretly acquired the major shareholding of Nippon Broadcasting System. Meanwhile, the Murakami Fund continued to acquire shares of Nippon Broadcasting System. Suddenly, both entities appeared as major shareholders.<sup>13)</sup> Such behavior was severely condemned because it would damage the fairness and transparency of the capital markets. Moreover, it was suspected that such investment funds might engage in insider dealing or giving false information regarding financial statements.

Mr. Horie was ultimately prosecuted for falsifying annual accounts and employing fictitious devices using investment funds that contravened the Japanese Securities and Exchange Law. In the first instance, the court found the accused guilty.<sup>14)</sup> Meanwhile, Mr. Murakami was also prosecuted for insider dealing. As a fund manager, he was closely involved in the contest for corporate control of Nippon Broadcasting System between Fuji Television Network and Livedoor. Murakami was convicted of insider dealing<sup>15)</sup> by the Tokyo District Court. According to the Court,

---

12) In Japan a parent company and its subsidiaries are often listed together on the stock exchanges. KENJIRO EGSHIRA, LEGISLATION AND CONSTRUCTION REGARDING TO THE LAWS OF COMBINED CORPORATIONS [*Ketsugo-kigyoho no Rippo to Kaishaku*] 1-2 (1995).

13) The reason that it was possible for the institutional investors to acquire and dispose of major holdings of the target company secretly was the relaxation of application of the requirements for the reporting of acquiring and disposal of major holdings. In consideration of the administrative workload for institutional investors engaged in a large volume of trading as part of daily business activities, a lower frequency of reporting is required. The frequency of reporting is strengthened for the institutional investors under JFIEL.

14) Judgment of the Tokyo District Court on March 16, 2007.

15) Criminal sanctions were imposed on Mr. Murakami including penal servitude for 2 years and a 3 million yen penalty with 1.1 billion yen assessment. Judgment of the Tokyo District Court, on July 19, 2007.

the attempt to take over Nippon Broadcasting System by Livedoor was based on “inside information.” Had this information been made public, it would likely have significantly affected the price of Livedoor shares.

The Livedoor and Murakami Fund cases have raised questions concerning deficiencies in the Japanese legal system regarding the capital market. In response to these cases, on February 17, 2006, the Liberal Democratic Party of Japan proposed ten recommendations for moving towards a fair and transparent capital market.<sup>16)</sup> These recommendations included review of the regulatory framework for non-regulated CIS, a tender offer system and mandatory reporting system of the acquisition and disposal of major holdings. These recommendations were a direct result of the behavior and activities of non-regulated CIS that might hurt the integrity of the capital market, such as in the Livedoor and Murakami Fund cases.

### *3. The Bull-Dog Sauce case*

Recently, the Bull-Dog Sauce Co., Ltd. case became the focus in both Japanese professional and public arenas. Even though Bull-Dog Sauce was not in bad financial straits, the reputable company was attacked by an offshore investment fund, namely Steel Partners Japan Strategic Fund. Steel Partners and its allies had acquired about 5.05% of Bull-Dog’s outstanding shares, and on May 18, 2007, the tender offer was published according to the Japanese Securities and Exchange Law. The offer price included a premium of about 15% in order to acquire all Bull-Dog Sauce shares. The owners of Bull-Dog Sauce were greatly diversified among public investors. The Bull-Dog Sauce Board of Directors was against accepting the tender offer by Steel Partners; then on June 24, 2007, Bull-Dog Sauce shareholders decided to alter the articles of incorporation concerning the distribution of share options without payment to each shareholder<sup>17)</sup> and they added a discriminate exercise clause. According to the discriminate exercise clause, Steel Partners and its allies could not exercise the share options that were distributed free because they were regarded as disqualified shareholders who were likely to devalue the company. Instead, they could receive the fair value of the distributed share options in cash.

---

16) Financial investigation committee and sub-committee for corporate accounting in Democratic Party of Japan, Moving towards fair and transparent capital market, on February 17, 2006.

17) Japanese Corporate Law, Article 277.

The shareholders' meeting of Bull-Dog Sauce Co. decided on the introduction of the plan and on the concrete distribution of three units of share options to each share. However, Steel Partners claimed that the distribution of the share options with the discriminate exercise clause should be suspended because it would be against the principle of equal treatment of shareholders and the share options would be issued in an extremely unfair manner. On June 28, 2007, the Tokyo District Court rejected the plaintiff's claim. The reason that the discriminate exercise clause does not contravene the principle of equal treatment of shareholders is that the clause ensures equal treatment regarding economic interests. According to the decision, approval at the shareholders meeting for executing the takeover defense in question is to be respected, and the measure was not disproportionate to the end, preventing a decrease in the shareholder value of the company. Both the Tokyo High Court and the Supreme Court of Japan rejected Steel Partners' appeal.<sup>18)</sup>

## **IV. Regulatory Framework for Units of Non-regulated CIS**

### *1. Risks of Non-regulated CIS*

Risks inherent in non-regulated CIS have raised three main regulatory issues in Japan. The first is investor protection problem. In the process of solicitation and sale it should be ensured that appropriate and correct information shall be provided and dealing of the units of non-regulated CIS should be in accordance with the best interests of the client, especially when non-professional investors are involved. The business should be conducted with clients fairly and in good faith. For example, in the investment management business, there are various conflicts of interest between fund managers and fund investors, between investors in separate funds that are managed by the same managers, and in cases of leveraged buyouts between investors

---

18) Decision of the Tokyo High Court on July 9, 2007; Decision of the Supreme Court of Japan on August 7, 2007. The Tokyo High Court decided that Steel Partners has used and treated the contest for corporate control of Bull-Dog Sauce Co. in such a way as to impair seriously the enterprise values of Bull-Dog Sauce Co. But this judgment was harshly criticized because of lack of enough evidence. The Supreme Court of Japan did not tell whether Steel Partners would impair the value of Bull-Dog Sauce Co. or not, but respected the approval of shareholders' meeting with over 80% majority.

and managers and an employee acting as a director of a target company owned by the fund. Advisers and leveraged finance providers face significant conflicts between their proprietary and advisory activities and among their different clients.

The second issue is to ensure the stability of financial markets and financial systems. The possible collapse of a large and leveraged investment fund would pose grave danger to the stability of the international financial market. Investment funds' activities would especially impact small and medium-sized markets. The discussion of how international non-regulated CIS like hedge funds should be regulated is heated on the international level. It seems that the mainstream considers that the direct regulation of non-regulated CIS by strict laws and regulations is less preferable to self-regulation. For the time being the European Commission, the Financial Stability Forum and a G8 Summit Declaration all require indirect supervision through stronger counterparty risk management, enhanced regulation of credit providers and increased risk sensitivity in regulating bank capital rather than direct supervision of non-regulated CIS.<sup>19)</sup> But the authority should have a power to collect and analyze information about the status and activities of non-regulated CIS, including international hedge funds.

The third issue is to ensure the transparency of capital markets. This is closely related to the second issue.<sup>20)</sup> The opacity of non-regulated CIS makes it unclear who will ultimately bear the risk. There is further widespread suspicion that non-regulated CIS might involve violation of laws and regulations, for example insider dealing and manipulation, which might injure the integrity of the market.

## *2. A Regulatory Framework for Units of Non-regulated CIS under JFIEL*

### *A. Second-class Security*

In Japan, there are two categories of collective investment schemes (CIS): strictly

---

19) GROWTH AND RESPONSIBILITY IN THE WORLD ECONOMY SUMMIT DECLARATION (G8 Official Document), Jun. 7, 2007, at § 7-8; Financial Stability Forum's (FSF) update of its 2000 Report on Highly Leveraged Institution.

20) For the principles and guidelines for the valuation and disclosure, see Technical Committee of IOSCO, Principles for the Valuation of Hedge Fund Portfolios — Final Report —, Nov. 2007, <http://www.iosco.org/library>; Hedge Fund Working Group, Hedge Fund Standards: Final Report, Jan. 2008, at § 6.2-6.3, <http://www.pellin.co.uk/HFWG/Final-Report/pdf>; AIMA, Guide to Sound Practices for European Hedge Fund Managers, § 3.5-3.6, <http://www.aima.org/uploads/GuidetoSoundPracticesforEuropeanHFMMay2007.pdf>

regulated CIS and loosely or non regulated CIS. Regulated CIS should be subject to strict laws, regulations and administrative rules. Most important are the Law of Investment Trust and Investment Corporation, the Law concerning Asset-backed Securities, the Real Estate Syndication Law, and the Law concerning the Regulation of Commodity Investment. These laws regulate a particular type of collective investment scheme comprehensively. Namely, they regulate such matters as setting up the scheme, the structure and organization of a special purpose vehicle (SPV) in the scheme, filing and overseeing of the fund, and the business code of conduct of related parties (for example, arrangers or management of SPV, disclosure and the qualification of fund managers). The units of strictly regulated CIS for investment trust and asset-backed securitization has already been deemed as “security” by the amendment of the Japanese Securities and Exchange Law in 1990 and is therefore subject to the regulations of the law, for example, disclosure requirements and prohibition of unfair dealing.

Outside strictly-regulated CIS there are various types of non-regulated CIS that are formed, such as civil law partnerships, undisclosed partnerships based on the Japanese Commercial Law, trusts, or for-profit or non-profit corporations.<sup>21)</sup> The units of some types of such CIS were at most partly regulated as “security” by the amendment of the Japanese Securities and Exchange Law in 2004, as far as the scheme purports to invest in securities. The Japanese Financial Instruments and Exchange Law of 2006 (JFIEL) expanded the definition of non-regulated CIS dramatically to cover any collective investment scheme which (a) collects money or similar properties from two or more persons, (b) conducts business using the money contributed, and (c) distributes profits or properties originating from the business to investors.<sup>22)</sup> These factors of non-regulated CIS are very similar to the Howey-test in American case law to define “investment contract” under the definition of “security”.<sup>23)</sup> In the United States the term “investment contract” had been broadly construed so as to afford the investors a full measure of protection. In the interpretation, the legal form is not regarded for substance, and emphasis is placed on

---

21) *See* Table 1.

22) JFIEL, Article 2, Paragraph 2, No. 5. A unit of collective investment scheme and any similar unit established in foreign countries should be also included under the definition of security under the law. *See* JFIEL, Article 2, Paragraph 2, No. 6.

23) *SEC v. W. J. Howey Company*, 328 U.S. 293 (1946).

economic reality. An investment contract thus came to mean a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment.

Just as with the Howey-test, under JFIEL the legal form of a fund is irrelevant, whether a unit of non-regulated CIS should be subsumed in the definition of “security.” Moreover, the sorts of assets and properties that a fund invests in and holds are irrelevant to the definition of “security.” It is however worth noting that a CIS is exempt from the law, when (a) all the investors are involved in the business,<sup>24)</sup> or (b) there is no distribution of profits or properties to investors beyond the amount of original investment. The Japanese Financial Services Agency made public its opinion concerning (a) that this exemption is restricted to the case where operations relating to the business for investment are conducted with the consent of all equitable partners and that all equity partners either engage in the business on a full-time basis or contribute to the business professional skills that are indispensable for maintaining that business, although not on full-time basis.<sup>25)</sup> According to that opinion, the exemption of (a) will be exceptional. Concerning (b), concrete rights or interests, for example, the right based on an insurance contract, are exempted.<sup>26)</sup> Due to this reform, the loopholes in regulations under the former law will be closed.<sup>27)</sup>

JFIEL makes the structure of regulatory framework more flexible and substance

---

24) JFIEL, Article 2, Paragraph 2, No. 5.

25) <http://www.fsa.go.jp/en/news/2007/20071119.html>

26) JFIEL, Article 2, Paragraph 2, No. 5. Under the exemption in the text mentioned (b) any of the following classes of securities are exempted from applying JFIEL: (1) other securities, (2) the right based on an insurance contract, mutual aid contract under the Agricultural Cooperative Law, mutual aid contract under the Small and Medium-Sized Enterprise, (3) the right based on cooperative associations in which participation is restricted to certified public accountants, lawyers, judicial scriveners, land and house surveyors, certified administrative procedures specialists, certified tax accountants, certified real estate appraisers, certified social insurance labor consultants or patent attorneys and those whose exclusive businesses for investment constitute the operation of such businesses, (4) the right based on a stock ownership plan, (5) the right relating to capital contribution for a corporation established in accordance with laws and regulations of Japan (except for a limited liability intermediate corporation) and (6) the right based on a contract relating to shared forest systems based on the Special Measures Law Concerning Shared Forest Systems.

27) Hideki Kanda, *The Fundamental Legal Concepts in Japanese Financial Services Act [Tôshi Sâbis Hô ni okeru Kihongainen]*, in *DESIGN FOR THE JAPANESE FINANCIAL SERVICES ACT [Tôshi Sâbis Hô heno Kôsô]*, at 10-15 (Hideki Kanda ed., 2005).

of regulations more sophisticated.<sup>28)</sup> The concept of “security” under JFIEF is classified into two groups from this point of view; namely “first-class security” and “second-class security.” While the first-class security is characteristic of higher liquidity in the securities market, the second-class security is less liquid. They conform to different type of rules with respect to disclosure requirements and financial instrument business regulations.

## B. Disclosure Requirements

The disclosure requirements for first-class security have to be fulfilled through Electronic Disclosure for Investors’ Network (EDINET<sup>29)</sup>), to make available important information about issuer and security to the public. However, it is not in principle required for second-class security like a unit of a non-regulated CIS to disclose information through EDINET.<sup>30)</sup> The reason that there is no disclosure requirement for a second-class security is due to lack of high liquidity.

However, if a non-regulated CIS invests mainly in securities under JFIEL, then the disclosure requirements for first-class security could be easily avoided. Therefore, the unit of such a CIS should be subject to the disclosure requirements in the same way as first-class security through EDINET, when the scheme invests mainly in securities and more than 500 investors participate in it.<sup>31)</sup> In that case, the concept of “offering” of units of non-regulated CIS is different from that of first-class security. The first-class security “private offer for a small number of investors,” that is exempt from applying disclosure requirements, means any attempt to solicit and offer to dispose of to less than 50 investors. On the other hand for the second-class security private offering means that less than 500 investors participate in the scheme and hold the units in the end.

---

28) THE JAPANESE FINANCIAL INSTRUMENTS AND EXCHANGE LAW [*Kinyu Shōhin Torihiki Hō*] 19-23 (Hidenori Mitsui & Tadakazu Ikeda eds., 2006).

29) Available at, <https://info.edinet.go.jp/EdiHtml/main.htm>

30) JFIEL, Article 3, No. 3, Article 2, Paragraph 2, No. 5.

31) JFIEL, Article 3, No. 3 and Order for Implementing the Financial Instruments and Exchange Law, Article 1-7-2.

### C. Conduct of Business Obligations

A firm engaging in the units of non-regulated CIS that fall under second-class security should be in principle subject to financial instruments business regulations. This type of business is labeled “second-class financial instruments business” under JFIEL. Second-class financial instruments business includes offering to the public or privately, placement, handling offering and placement with issuer’s commitment, sale, executing and transmitting client orders regarding the units of non-regulated CIS.<sup>32)</sup> Registration is required with the Japanese Financial Services Agency<sup>33)</sup> to commence the business. Secondly, the financial instrument firm has to comply with capital requirements.<sup>34)</sup> The financial instrument firm, including its management and employees, owes an obligation of good faith and fair practice to clients.<sup>35)</sup> It should collect information about each client and conclude the financial instrument transaction contract in respect of his or her knowledge, experience, assets and the purpose of the client’s investment.<sup>36)</sup> The firm should not provide inaccurate information or conclusive recommendation about units of non-regulated CIS<sup>37)</sup> and is subject to the restriction on advertisements.<sup>38)</sup> These regulations should also be applied to foreign firms that engage in the units of non-regulated CIS.

Although the significant information about second-class security cannot be found for investors or prospective investors through EDINET, it is provided directly to an investor by a financial instrument firm with whom he or she concludes a financial instrument transaction contract. A person involved in units of non-regulated CIS should deliver a written document prior to entry into a financial instrument transaction contract,<sup>39)</sup> where matters relating to risks and accounting of the CIS are

---

32) JFIEL, Article 28, Paragraph 2.

33) JFIEL, Article 29.

34) JFIEL, Article 29-4, Paragraph 1, No. 4 and Order for Implementing the Financial Instruments and Exchange Law, Article 15-7, Article 1, No. 4. The minimum capital requirement is 10 million Yen for the second-class financial instruments business.

35) JFIEL, Article 36.

36) JFIEL, Article 40 states so-called suitability rule.

37) JFIEL, Article 38, No. 1 and 2.

38) JFIEL, Article 37.

39) JFIEL, Article 37-3 and Cabinet Office Ordinance on Financial Instruments Business, Article 82. On the

to be described. An investor can obtain information to ensure that he or she could make a decision on the contract properly and rationally. Moreover, the financial instrument firm has to deliver a written document at the closing of the transaction.<sup>40)</sup> An investor might confirm the contents of his or her financial instrument transaction contract and keep the evidence of the contract.<sup>41)</sup>

There was no regulation under the former Japanese Securities and Exchange Law on offering of the units of non-regulated CIS and investment management of the assets of the CIS by the fund itself or its members. Under the former law neither offering nor investment management by an issuer itself or its members was considered as securities business because no regulation seemed necessary for these activities. Therefore, a business company itself could issue securities and invest its assets mainly in securities without applying securities laws and regulations. However, JFIEL has introduced regulations on the self-offering of the units of non-regulated CIS<sup>42)</sup> and self-investment-management of the assets of the CIS contributed

---

document the following matters are to be described: (a) Corporate name or, in the case of an individual, full name and address, (b) the fact that it is a financial instrument firm and its registration number, (c) contents of the financial instrument transaction contract, (d) matters relating to the fees and similar considerations to be paid by clients, (e) matters relating to risks, (f) notice that a client must read and understand the contents thereof, (g) outline of taxation relating to financial instrument transaction contracts, (h) outline of the financial instrument firm and the Financial Instruments Business to be carried out, (i) means for clients to contact the financial instrument firm, (j) whether or not the financial instrument firm is a member of a financial instruments business association and if applicable, the name of the association, (k) when there are any restrictions on the transfer of securities, the fact and details thereof, (l) matters relating to accounting of the CIS, (m) the following matters when the CIS is formed under foreign laws and regulations; (i) name and content of the law that governs the CIS, (ii) name and major operations of the foreign authority that supervises the issuer of the interests of the CIS, (iii) handling of remittance of dividends under the foreign exchange control in question, (iv) whether or not the foreign CIS has an attorney who has the right to represent the issuer in Japan and if applicable, his or her full name and other names, and (v) the court that has jurisdiction over lawsuits regarding the scheme.

40) JFIEL, Article 37-3 and Cabinet Office Ordinance on Financial Instruments Business, Article 99. On the document the following matters are to be described: (a) corporate name or in the case of an individual, full name, (b) name of sales office or other office, (c) outline of the financial instrument transaction contract and the date of the closing of the transaction contract, (d) matters relating to the fees and other considerations to be paid by the client, (e) client's full name or denomination, (f) methods for clients to contact the financial instruments business, (g) selling or purchasing, name of issue, contracted volume, price, the amount to be paid by the client and types of trading.

41) JFIEL has categorized investor according to its attribute; professional investor and non-professional investor. To the professional investors the most provisions about conduct of business obligations under JFIEL do not apply. JFIEL, Article 45.

42) JFIEL, Article 2, Paragraph 8, No. 7, Article 28, Paragraph 2, No. 2.

by investors.<sup>43)</sup> The reason that JFIEL regulates self-offering and self-investment management is explained in that these activities are virtually directly for the investors because the scheme is just a formality and therefore should be neglected. According to the regulation, a person engaging in self-offering or self-investment-management has to be registered with the Japanese Financial Agency, irrespective of the categorical attributes of its counterparty, for example a qualified institutional investor, professional investor or non-professional investor. The regulation for the second-class financial instruments business, as stated above, ought to be applied to self-offerings. The regulation for investment management business should be applied to self-investment-management.

When a firm engages in investment management of assets of a non-regulated CIS, it must be registered with Japanese Financial Services Agency, and it has to obey not only regulations for the financial instruments business but also special regulations for the investment management business. Generally, an investment manager owes fiduciary duty, namely duty of loyalty and duty of care.<sup>44)</sup> As a concrete rule, the investment manager of a non-regulated CIS should manage the assets of the fund properly separated from the assets of the manager or other investment funds.<sup>45)</sup> The rule regarding conflicts of interest is in detail embodied in the law and regulation. The following types of conduct should be prohibited for the investment manager:<sup>46)</sup> (a) investing in transactions through its own accounts or those of its directors or executive officers, (b) investing in mutual transactions between portfolio assets, (c) engaging in transactions that are not in the rational course of investment in respect to specific financial instruments, financial indexes or options for the purpose of obtaining benefits for a third party other than itself or authorized beneficiaries by utilizing the fluctuations of prices, indexes, figures or an amount of consideration that would result from such transactions, (d) investing in transactions for which the terms and conditions are different from usual transactions and would be detrimental to the interests of investors, and (e) selling or purchasing securities or engaging in other transactions in one's own account by utilizing information obtained in the course of transactions made as an investment management business.<sup>47)</sup>

---

43) JFIEL, Article 2, Paragraph 8, No. 15, Article 28, Paragraph 3, No. 3.

44) JFIEL, Article 42.

45) JFIEL, Article 42-4 and Cabinet Office Ordinance on Financial Instruments Business, Article 132.

46) JFIEL, Article 42-2.

#### D. Special Rules for Funds for Qualified Institutional Investors

In the case of funds involving qualified institutional investors, only notification, not registration, will be required. This will enable the Japanese Financial Services Agency to collect data for non-regulated CIS, including hedge and private equity funds.

Conduct of business obligations will not be in principle applied to a fund unless it involves non-professional investors.<sup>48)</sup> The code of conduct requirements shall be satisfied where fund units will be solicited and sold only to non-professional investors, to more than 50 non-professional investors, or to more than one qualified institutional investor. On the other hand, only limited regulations could apply to funds involving professional investors. This is meant to help compensate customers for their losses and to prohibit the provision of false information.<sup>49)</sup> Minimum regulations are considered necessary for ensuring the fairness of transactions. Therefore, the prohibition of false reports and the compensation for losses apply to a person who is filing for special business activities for qualified institutional investors.

### V. IOSCO MOU

In principle, the regulatory framework for non-regulated CIS conducting their business on cross-border bases should be established according to a risk-based approach. The introduction of special regulations for hedge and private equity funds should be examined in connection with the problems that they might actually raise. Therefore, fact-finding would provide a useful and important starting point. For the appropriate monitoring and regulating of international non-regulated CIS, international cooperation and exchange of information play an important role. Since the majority of international hedge funds and private equity funds distributed in Japan are established and managed overseas, it is necessary to enhance cooperation

---

47) JFIEL, Article 42-2 and Cabinet Office Ordinance on Financial Instruments Business, Article 128-130.

48) JFIEL, Article 34 to 45.

49) JFIEL, Article 63 to 63-4.

with foreign regulators.

According to the increasing international activity in the securities markets and the corresponding need for mutual cooperation and consultation, IOSCO established the Multinational Memorandum of Understanding (MOU) among IOSCO members to ensure compliance with and enforcement of their securities laws and regulations.<sup>50)</sup> IOSCO adopted in 2005 the effective implementation of IOSCO Principles and of IOSCO MOU, which are considered primary instruments to facilitate cross-border cooperation, reduce global systemic risk, protect investors and ensure fair and efficient securities markets. It is necessary for a competent authority to participate in MOU to be recognized by IOSCO as the authority with full legal powers and competence to enforce and secure compliance with its laws and regulations.

The Japanese Financial Services Agency finally became a signatory to the IOSCO MOU on February 19, 2008. One of the reasons that the participation of the Japanese Financial Services Agency in MOU was so late might be because of the Japanese legal system, especially Article 189 of the Japanese Financial Instruments and Exchange Law.<sup>51)</sup> Article 189 of JFIEL refers to cooperation and provision of information required by foreign competence authorities for the purpose of assisting in their administrative investigation. However, it prohibits the provision of information for the purpose of assisting in prosecuting a crime in foreign countries. The lack of authority to provide information of the Japanese Financial Services Agency to assist in a criminal prosecution might hinder international cooperation in this area.

On the other hand, IOSCO has adopted new strategy that, by January 1, 2010, all IOSCO members should be a signatory to the IOSCO MOU. Research by IOSCO suggested that the inability to meet the IOSCO MOU requirements is the greatest impediment to joining the MOU.<sup>52)</sup> Therefore, IOSCO would apply the MOU requirements not strictly on judgment whether an authority has full legal powers and competence to enforce its laws and regulations. Although It was perhaps lucky the Japanese had competent authority to participate in the IOSCO MOU earlier than

---

50) IOSCO, Multinational Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, May 2002.

51) Article 189 of JFIEL is substantially the same as article 189 of the former Japanese Securities and Exchange Law.

52) Emerging Markets Committee of IOSCO, Obstacles to Joining the IOSCO MOU, Apr. 2007, at 16.

expected, the legal problems still remain unsolved. Article 189 of JFIEL might have to be reviewed to enforce and secure the international cooperation between securities regulators appropriately and expeditiously.

In using information provided or exchanged by the IOSCO MOU about the conduct of non-regulated international CIS, especially international hedge and private equity funds, we should carefully observe their particular risks, which might require additional regulation.

## VI. Conclusion

The Japanese Financial Instruments and Exchange Law, which took effect on September 30, 2007, established a comprehensive definition of non-regulated collective investment schemes. The units of non-regulated CIS, including hedge funds and private equity funds established in offshore financial center, could fall within the definition of “second-class securities,” unless they meet the requirements for exemption.<sup>53)</sup> Although his reform is noteworthy because loopholes in the securities regulations are going to be closed, the regulations of funds for qualified institutional investors are not at all strict. The most important regulation of such a fund is the mandatory notification of self-offering or self-investment-management with the Japanese Financial Services Agency. The notification might enable the Japanese Financial Services Agency to collect and analysis information about the status and conduct of such a non-regulated CIS. This means that the fact finding about the non-regulated CIS might lead to re-examination of the additional regulatory framework for particular types of funds (for example, hedge funds and private equity funds), notwithstanding that the present Japanese legislation has no special regulation.

Finally, I point out two legal issues that might require additional regulation of non-regulated CIS: the disclosure problem and the conflicts of interest problem.

First: The Japanese Financial Instruments and Exchange Law deems generally a unit of non-regulated CIS as a “second-class security.” A person engaging in a non-

---

53) THE JAPANESE FINANCIAL INSTRUMENTS AND EXCHANGE LAW [*Kinyu Shôhin Torihiki Hô*], *supra* note 28, at 218-19.

regulated CIS should consequently deliver a written document prior to entry into a financial instrument transaction contract and at the closing of the transaction also a financial instrument to enable potential or actual investors directly to make well-informed decisions. On the other hand, the rigid public disclosure requirements about “second-class security” through the Japanese Electronic Disclosure Network are in principle exempted. It needs to be discussed whether the present disclosure requirements relating to the units of non-regulated CIS are sufficient in breadth, clarity and frequency.

Second: A non-regulated CIS often has a complex legal structure and many related parties participate in it. There might be many types of conflicts of interest not only between investment manager and investors but also between other participants, such as the prime broker and investors or among investors. The conflicts of interest problem might raise a huge risk to the integrity of the securities market and the trustworthiness of investors in the securities business and financial instruments. The rules and regulations have to be sophisticated without disturbing financial evolution and innovation. It is worthwhile mixing the regulation and self-regulation adequately to develop the best practice.

KEY WORDS: Collective Investment Scheme, Hedge Fund, Private Equity Fund, Securities, Securities Regulation