

Financial System Council
Report on the “Working Group on Investment Management”

- **How Financial Systems Relating to Funds for Professional Investors Should Function with the Aim of Protecting Investors and Securing the Smooth Supply of Growth Capital -**

January 28, 2015

List of Members of the Working Group on Investment Management

As of January 28, 2015

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	Tetsuya Isozaki	General Partner, Femto Growth Capital LLP
	Toshiro Ueyanagi	Partner, Attorney at Law (Tokyo Surugadai Law Offices)
	Sadakazu Oosaki	Head of Research, Nomura Research Institute, Ltd.
	Yo Ota	Partner, Attorney at Law (Nishimura & Asahi)
	Masami Okino	Professor, University of Tokyo Graduate Schools for Law and Politics
	Kazunori Ozaki	Chairman, Japan Venture Capital Association
	Takahito Kato	Associate Professor, University of Tokyo Graduate Schools for Law and Politics
	Hiroyuki Kansaku	Professor, University of Tokyo Graduate Schools for Law and Politics
	Tatsuya Kuroda	Vice President, Graduate Institute for Entrepreneurial Studies
	Etsuro Kuronuma	Professor, Waseda Law School
	Yuichiro Saka	Partner, Attorney at Law (Tokyo - godo Law Offices)
	Yuko Tashima	Partner, Attorney at Law (Sawayaka Law office)
Yumiko Nagasawa	Secretary General, Foster Forum	
Etsuko Masuda	Senior Managing Director, Japan Association of Consumer Affairs Specialists	
Nobuyoshi Yamori	Professor, Research Institute for Economics and Business Administration, Kobe University	

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	Keisuke Sasaki	Director, Industrial Finance Division, Economic and Industrial Policy Bureau, Ministry of Economy, Trade and Industry
	Yasushi Kobayashi	Director, Real Estate Market Division, Land Economy and Construction Industries Bureau, Ministry of Land, Infrastructure, Transport and Tourism
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	Masayuki Shimamura	Secretary General, Type II Financial Instruments Firms Association
	Kazuaki Masuda	Chair of the Self-Regulation Committee, The Investment Trusts Association, Japan
	Takeshi Okazaki	General Manager, Planning Division, Japan Investment Advisers Association

Introduction

Funds have been playing an increasingly significant role in the supply of risk capital at home and abroad. In Japan, when a fund is created, it is basically necessary for it to be registered as an investment management business or an investment management business for qualified investors, etc., but when such fund collects capital from professional investors such as qualified institutional investors, etc., it may conduct business by notification as a specially permitted business for qualified institutional investors, etc. (so-called “Fund for Professional Investors”).

When the Financial Instruments and Exchange Act was established, proper attention was paid to ensure that the regulation would not become excessively tight to avoid inhibiting financial innovation, whereas comprehensive and horizontal regulations on funds were improved from the perspective of fully enforcing investor protection rules. As a result, while it was determined that a fund business operator engaging in sale, solicitation and management for general investors would be subject to the registration system, funds for professional investors and a small number of non-professional investors would be subject to the notification system and under simple conduct control.

However, the number of cases of investors suffering damage has been increasing due to the fact that business operators conducting sale of funds for professional investors are abusing the provisions that such operator is (1) under laxer conduct control than other financial instruments business operators, and is not subject to administrative action (order of business improvement/suspension and order of rescission of registration); and (2) entitled to sales to not more than 49 ordinary investors.

Against the increase in these incidents of damage suffered by investors, the Consumer Commission and the Securities and Exchange Surveillance Commission made a recommendation and a proposition in April 2014 that the relevant systems, including the requirements for investors, be revised and tightened. Based on such recommendation, etc., in order to get back to the original purposes of funds for professional investors, the revision of the relevant system to limit the investors to whom such fund can be sold has been conducted by implementing the public comment process (from May 14 to June 12, 2014) concerning the proposed revisions to the Government Ordinance and the Cabinet Office Ordinance.

In this process, concerning the proposed revisions attached to the public comments, several opinions were expressed as follows: “The sale of funds for professional investors to individual investors should be prohibited,” and “The scope of investors to whom funds can be sold is too small for the creation of new funds. Therefore, the scope should be much wider.”

Based on this background, the Minister for Financial Services made an inquiry to the Financial Systems Council in September 2014 on “Considering the challenges of how the system for so-called funds for professional investors should function from the viewpoint of investor protection and smooth supply of growth capital.” Following this consultation, the Financial

Systems Council established the “Working Group on Investment Management,” and held discussions six times from October 2014. From the perspective of investor protection and smooth supply of growth capital, the Council proceeded with discussions while holding hearings with the interested parties of venture capital and consumers with the aim of obtaining a well-balanced and definitive proposal.

This report has summarized the results of the discussions by the Working Group, and we expect that the interested parties will appropriately improve and operate the system in the future based on the intention of this report.

Chapter 1. Situation of Funds for Professional Investors

1. Protection of investors and smooth supply of growth capital

As described earlier, funds have played a major role in the supply of risk capital at home and abroad. Considering the significant role that the supply of risk capital plays in economic growth, it is required that the growth capital be supplied smoothly by funds from the viewpoint of considering how the financial systems relating to investment management, etc., should function. In particular, venture capital of which the entry rate of 10% or more is pursued in the Japan Revitalization Strategy, plays the role of assisting “the acceleration of venture businesses” as stated in the same strategy by supplying capital for start-ups, construction of business, market development, etc., in frontier domains and growth domains, and participating in management together with the entrepreneurs. Thus, it is necessary to take the importance of their role into consideration.

On the other hand, under the specially permitted business for qualified institutional investors, etc. (“Funds for Professional Investors”) system, the reality is that ordinary (amateur) investors are increasingly suffering damage due to fraudulent solicitation. It is critical to properly prevent this damage to investors in order to smoothly supply growth capital by protecting investors and securing trust in the funds.

Based on this perspective, we must create a framework of systems pertinent to investment management, etc., which is coherent as a whole.

2. Status of regulations applicable to fund managers and fund distributors outside Japan

In foreign countries (the United States, Europe and Singapore), regulations regarding funds were tightened following the most recent financial crisis, and a registration system, an authorization system or a license system is adopted. As an exception, the notification system remains in the United States for venture capital, but even under the notification, the submission and disclosure of almost the same contents of information as in the registration system are required, and are subject to the relevant conduct regulations and administrative actions. With respect to sale, while it can be handled as a private placement under the notification system, those who are allowed to purchase the fund are limited to accredited investors and no more than 35 sophisticated investors.¹

¹ In Europe, a fund manager is, in principle, subject to the authorization whereas a small-sized manager is under the registration pursuant to the Alternative Investment Fund Managers Directive (AIFMD), which was established after the financial crisis. The authorization system includes conduct control, and a violation is subject to administrative action. (The AIFMD does not provide for conduct control for the registration system, but the regulations of each country govern the matter. For example, conduct control is set forth in the United Kingdom and some other countries.) The sale of funds is, in principle, solicited to professional investors. As to venture capital, there is the Regulation on European Venture Capital Funds (EuVECA), and a fund can be solicited within the EU if registered with the relevant country’s authorities. EuVECA also provides for both conduct control and

3. Types of damage relating to the specially permitted business for qualified institutional investors, etc.

The following types of damage and problems have been reported relating to Funds for Professional Investors.

(1) About qualified institutional investors

- Only a small amount of investment is obtained from an Investment LPS as a qualified institutional investor, which is relatively easy to establish, and the rest of the investment is obtained from ordinary individual investors.

(2) Person making notification on the Specially Permitted Business for Qualified Institutional Investors, etc.

- While a notification has been submitted, there seem to be problems in the personnel and property bases of the fund operator as shown by the fact that actually almost no investment was made from qualified institutional investors, or that fraudulent solicitation was conducted.

(3) Status of the person making notification

- Capital invested was diverted to investments which were different from those agreed upon, and to expenses of a company unrelated to the fund, private expenses, dividends and redemptions paid to other customers, etc.
- The details of the management were not fully disclosed and governance was not secured. The documents of the investments by customers were not properly stored, and the status of management of the fund by the trustee was not followed, either. In addition, the appropriateness of accounting was not secured.

(4) The scope of equity investor for the specially permitted business for qualified institutional investors, etc.

- Ordinary investors and elderly people with limited investment experience have suffered damage, and damage recovery is often extremely difficult.

supervision rules. In Singapore, the regulations for the fund management business were tightened subsequent to the financial crisis and the Madoff scandal. The fund management business is currently subject to the license system or registration system (in the case of small-sized and qualified investors), conduct control, and supervision.

Chapter 2. How the Specially Permitted Business for Qualified Institutional Investors, etc. system should be.

Given the aforementioned problem of damage associated with the specially permitted business for qualified institutional investors, etc., system and the actual situations of regulations on overseas fund management/sales business operators, the comprehensive measures as described below, not limited to reviewing the scope of equity investors, as well as legal actions including amendments to laws will be necessary to secure the smooth supply of growth capital while protecting investors.

1. Person making notification on the specially permitted business for qualified institutional investors, etc.

A certain qualification is required for a fund manager. Therefore, it is appropriate to take measures as listed below for the person making notification on the specially permitted business for qualified institutional investors, etc.

- (1) Certain requirements on qualification including refusal requirement and causes for disqualification.
- (2) Contents of notification forms and attached documents thereto should be increased. Furthermore, the contents of notification forms, etc., and the explanatory documents relating to the outline of business should be disclosed (via the internet or by making them available for public inspection at branch offices and offices) by reference to the examples in the United States.

2. Positioning of qualified institutional investors

The specially permitted business for qualified institutional investors, etc., was basically established for qualified institutional investors, and therefore, the relevant regulations were made simple to avoid inhibiting financial innovation. However, it is supposed that at the time of the enforcement of the Financial Instruments and Exchange Act, there were actual cases in which basically, even if qualified institutional investors invested in a fund, ordinary investors closely related to the relevant fund (for example, an executive of the fund operating company, etc.) may have also invested in the same fund. Based on such situation, the regulations may have been made simple in the same manner when such kind of investors were limited to a small number.

At this point, the appropriateness of the operation of the fund may have been expected to be secured to a certain degree if a qualified institutional investor makes an investment in order to be involved in the relevant fund for itself.²

² Attention must be paid in this regard that a qualified institutional investor is not subject to the regulations of the

In light of the actual damage that indicates many problems on the side of qualified institutional investors, it is appropriate that the following measures be taken with respect to the scope and qualification of qualified institutional investors.³

- (1) Problems are often found in qualified institutional investors as equity investors, particularly investment LPS. With the aim of excluding investment LPS that are unsubstantial as an equity investor, it is important to create an asset requisite (for example, outstanding assets under management (except for borrowings) should be 500 million yen or more) for an investment LPS qualified as a qualified institutional investor under the specially permitted business for qualified institutional investors, etc., system, taking into consideration the asset requisite associated with a stock company and other legal entities.⁴
- (2) If only qualified institutional investors which are controlled by a business operator conducting the specially permitted business for qualified institutional investors, etc., make investments just for form's sake as qualified institutional investors, such case should not be authorized as a specially permitted business.

3. Conduct control for person making notification

Considering the actual damage suffered by investors and the systems adopted by other countries, it would be appropriate to establish similar regulations of conduct control as in the case of the registration system even under the notification system.

- (1) In light of the actual situations of damage suffered by investors, the following rules associated with conduct control should be established for the person who conducts the specially permitted business for qualified institutional investors, etc., in addition to prohibition of false explanation and compensation for losses which is already set forth.
 - Duty of loyalty and duty of due care of prudent manager
 - Duty to segregate property
 - Prohibition of transaction acts that damage investor interests
 - Principle of suitability
 - Prohibition of provision of conclusive evaluations
 - Duty of delivery of document prior to, and upon, conclusion of contract

industry, such as conduct control, under the Financial Instruments and Exchange Act.

³ In addition, given the tendency of a few qualified institutional investors to have invested in problematic funds, it would be appropriate to require disclosure of the amount or the percentage of investment in the fund from qualified institutional investors concurrently with the announcement of the explanatory documents on the outline of business.

⁴ In the event that the outstanding assets under management are not fixed at the time of the submission of notification, and that it is inevitable to disclose the estimate amount, it would be practicable, for example, to adopt a measure such as requiring the operator to submit documents that confirm that the fund actually holds the assets, and additional documents after the elapse of a certain period of time.

- Duty of delivery of investment report, etc.

- (2) On the other hand, from the perspective of not inhibiting free transactions among professional investors, and in the case of accepting investments from specified investors, the transactions with specified investors should not need to apply the principle of suitability, duty of delivery of document prior to, and upon, conclusion of contract, duty of delivery of investment report (if an individual inquiry can be answered immediately), etc., with respect to transactions with specified investors, following the provisions of the Financial Instruments and Exchange Act and other rules.
- (3) As to the specially permitted business for qualified institutional investors, etc., the explanations on the nature and high risk of the relevant business and that only limited investors can invest in the fund should be obligatory.
- (4) Preparation, submission to the relevant authority of business reports associated with the specially permitted business for qualified institutional investors, etc., as well as book-keeping should be obligatory for the person making notification, too.

4. Actions to be taken against a problematic person making notification

Effective measures need to be taken against a problematic person making notification among the persons conducting the specially permitted business for qualified institutional investors, etc. The following measures are considered appropriate:

- (1) If the person making the notification on the specially permitted business for qualified institutional investors, etc., causes a problem, it should be determined that the improvement, suspension or abolishment of business can be ordered.
- (2) Raise the penalty for failure to make a notification or making a false notification on the specially permitted business for qualified institutional investors, etc. (currently, imprisonment of up to one year, or a fine of 3 million yen or less)
- (3) Raise the penalty for violation, etc., of the report on investigation for a petition to a court concerning a violation of the Financial Instruments and Exchange Act (Article 187 of the same Act), and a penalty for violation, etc. of the order to submit items (currently, an administrative penalty is 100, 000 yen or less).
- (4) With respect to inspection of Specially Permitted Business for Qualified Institutional Investors, etc., it should be clarified that an inspection can be conducted against the person making the notification on the specially permitted business for qualified institutional investors, etc., from the perspective of the protection of investors.⁵

⁵ The current authority of inspection associated with specially permitted business for qualified institutional

(5) From the perspective of preventing the expansion of damage suffered by investors, the scope of target for the prohibition order issued by court should also be expanded to cases other than violation of laws or orders.

Furthermore, it is necessary to enhance the personnel system to properly establish the enforcement system for effective implementation of the aforementioned measures.⁶

5. Scope of equity investors of the specially permitted business for qualified institutional investors, etc.

With respect to the scope of equity investors of the Specially Permitted Business for Qualified Institutional Investors, etc., it is appropriate to limit it to a certain investor with capacity for an investment decision and a person closely related to the specially permitted business operator, considering the actual situations of Funds for Professional Investors in which ordinary investors closely related to the funds also invest despite its original nature being a system for professional investors.

Based on such concept, and concurrently considering that the aforementioned measures will be taken, it might be appropriate to add modifications to the draft revision attached to the public comment issued in May 2014 to the effect that the scope of equity investors will be expanded as follows.⁷ It is, however, necessary to note that basically the principle of suitability will also apply to this kind of investor as mentioned earlier, and it is required that the pros and cons be individually judged for each investor at the stage of determination of solicitation in light of the principle of suitability.^{8 9}

(1) In the case of a joint-stock company, the standard should include not only capital stock but also net assets. In addition to a joint-stock company, other legal entities should be treated in the

investors, etc., is set forth assuming an inspection of the status of self-management of business operator of the specially permitted business for qualified institutional investors, etc.

⁶ Under the enforcement, it is important to properly cooperate with the investigative authorities, etc., depending on the individual case.

⁷ It would be appropriate to define that, if this kind of person is included in the scope of equity investor at the time of investment in a fund for professional investors, the fund will be able to continue to manage property during a period until the end of the management of the relevant fund, without returning the relevant investment. As to a qualified institutional investor, however, such an investor must remain a qualified institutional investor consistently not only at the time of investment in the fund but also during the period until the end of the management of the relevant fund. This reflects one of the purposes of the system that expects a certain degree of appropriateness of the status of fund management, etc., when a qualified institutional investor makes an investment to be involved in the relevant fund. Also, if an investor fails to satisfy the qualification as an equity investor, it would be appropriate that a renewed solicitation is not be permissible at such time and thereafter.

⁸ Basically, considering the purposes of a fund for professional investors targeting qualified institutional investors, it would not be appropriate if the major investors consist of the persons as listed in paragraphs (2) and (4). Therefore, it will be reasonable to take some steps to maintain the percentage of investment by these persons to less than a certain level.

⁹ As to the scope of equity investors, an opinion was expressed to the effect that the scope of equity investors to whom a fund can be sold should be clarified with the aim of securing the effectiveness of enforcement.

same manner.¹⁰

(2) The following persons should be included as those closely related to a person making notification on the specially permitted business for qualified institutional investors, etc. (a specially permitted business operator)

- Parent company, etc., subsidiary, etc., entrusted fund manager, investment advisor of the relevant specially permitted business operator
- Executives, employees and their relatives within the third degree of the parent company, etc., subsidiary, etc., entrusted fund manager, investment advisor of the relevant specially permitted business operator.

(3) The central government and local governments should be included.

(4) In addition to the above, considering that venture funds play the role of supplying growth capital, etc., and that there is a case in which such venture funds are treated in a different manner in the United States and other countries, the following points should be taken into account as preconditions for the establishment of appropriate systems:

- Secure appropriate governance (conforming to a model agreement of an Investment LPS).
- Submit a fund agreement, etc.
- Organize a general meeting and disclose financial information (to investors).
- Implement accounting audits by certified public accountants or an auditing firm of financial statements (of the fund in which non-professional investors have invested), and disclose the name of the certified public accountants, etc.

The following persons should be included as persons with capacity of investment decision.

- Executives, former-executives of a listed company, etc.,¹¹ managing partners, and former managing partners of the fund, etc.¹²
- Individuals and legal entities, etc., listed as in the top 50 (in the Securities Registration Statements) or 10 (in the Annual Securities Report) shareholders, etc., of a listed company,

¹⁰ Considerations should be taken so that investment by overseas institutional investors who do not have juridical personality is not inhibited.

¹¹ For example, a legal entity eligible for investment in the specially permitted business for qualified institutional investors, etc. It is possible that such entity is a listed company and a legal entity with capital stock or net assets of 50 million yen and more, etc.

¹² As to a former executive and a former managing partner, etc., it may be practicable that about five years, for example, should have passed since retirement. If such person made an investment in the fund, it would be appropriate to allow such person to reinvest if continuing to have the capacity to make investment decisions.

etc., that submits Securities Registration Statements or an Annual Securities Report.

- Certified public accountants, attorneys at law, judicial scriveners, administrative scriveners, certified tax accountants, etc., authorized as a Management Renovation Assisting Organization.
- Persons who have experience in directly engaging as executives, employees, consultants, etc., for a certain period (e.g. about one year) in business practices, such as the establishment of a company, capital increase, issuance of stock acquisition rights, start-up of a new business, formulation of management strategies, corporate finance, investment, organizing a general shareholders' meeting or a board of directors' meeting, acquisition or listing of issued shares on a financial instruments exchange, and who have professional expertise and capability associated with the relevant practices.
- A company controlled by such person as mentioned above who is capable of investing.

(5) In this case, the definitions of venture fund should be as follows in reference to example cases in the United States and Europe.

- (i) Stock investments, etc., in unlisted companies must comprise, 80% or more of the total, for example.
- (ii) In principle, there may be no leverage.
- (iii) In principle, there may be no early redemption.
- (iv) The fund has clearly explained that the company maintains its investment strategies as a venture fund.

Furthermore, in connection with these revisions, it will be appropriate to discuss necessary issues concerning the scale of the investment management business for professional investors, which is subject to a registration system and is stricter than a notification system.

6. Others

Regarding a "Danna Fund," a fund in which a local successful entrepreneur provides capital, etc., as an Angel Investor to a local venture capital company to offer assistance to junior investors, it can be positioned as an important function from the perspective of smooth supply of growth capital by local funds. Therefore, given the capacity of investment decision by the present investor, it will be possible to address the issue within the framework of the "Fund for Professional Investors" if the abovementioned proposal is adopted.

Meanwhile, a fund engaging in the photovoltaic power generation business by collecting funds

from ordinary individual investors who seek returns is also considered as playing a socially important role. However, given that the trust must be secured based on appropriate investor protection, such fund will be able to conduct business under the general registration system (Type II Financial Instruments Business) as stipulated in the Financial Instruments and Exchange Act, or in the framework of investment-type cloud funding of which the legal system has been improved recently.

End.