IFLR
INTERNATIONAL FINANCIAL LAW REVIEW

A Euromoney Publication

The IFLR Guide to

Japan 2007

An exclusive reprint for

Nishimura & Partners

Japan's securities regulations: following in US footsteps?

Adam Wiseberg and Kei Ito of Nishimura & Partners compare Japan's new securities law with its US counterpart, contemplating what would happen if US federal securities law applied

In June 2006, sweeping amendments to Japan's Securities and Exchange Law (Law 25 of 1948, as amended; the SEL), the Japanese counterpart to the US Securities Act of 1933 and Securities Exchange Act of 1934 combined, passed the Japanese diet, parts of which changed the definitions of securities and securities business and the name of the law itself. The SEL will be renamed the Financial Instruments and Exchange Law (the FIEL). These amendments will be effective within 18 months of enactment, expected as early as the mid-2007. The FIEL imposes an entirely new regulatory framework on investment funds, such as private equity funds, that take the form of a partnership.

FIEL on partnerships

General partnership
A general partnership (*nini kumiai*) is a partnership established under Japan's Civil Code (Law 89 of 1896, as amended). In a typical investment fund using the form of a general partnership, one of the members is appointed as an operating partner to operate the partnership's business. The operating partner acts as the manager of the fund.

Japanese investment limited partnership
A Japanese investment limited partnership (JLP) is a Japanese domestic vehicle established under the Law concerning the Investment Limited Liability Partnership Agreement (Law 90 of 1998, as amended; the JLP Law). A typical JLP consists of one general partner and one or more limited partners. The general partner acts as the manager of the fund.

Anonymous partnership
An anonymous partnership (*tokumei kumiai*; TK) is an agreement between an operator and an anonymous partner, established under the Commercial Code of Japan (Law 48 of 1899). In a TK agreement, an investor, as the anonymous partner, agrees to contribute capital to the business that the non-investing partner will operate. Under a TK, the operator agrees to allocate and distribute profits of the TK business to the anonymous partner. Typically, the operator serves as the manager of the fund. If there is more than one anonymous partner, the operator executes a separate, bilateral TK agreement with each investor, each consisting of essentially identical terms and conditions.

Offshore limited partnership
Offshore limited partnerships established under non-Japanese law are often used as vehicles for investment funds. For example, a limited partnership formed under the laws of the Cayman Islands is a popular vehicle used for funds investing in companies in Japan.

An offshore limited partnership provides as an example to discuss the amended definition of securities, as it offers a good illustration as to how the framework changes. The interests in an offshore limited partnership are recognized as securities if the partnership is regarded as similar to a JLP. Whether an offshore limited partnership is similar to a JLP depends on the business in which the partnership engages. To satisfy the similarity requirement, it is generally considered that an offshore limited partnership must be engaged in all or part of the categories of a JLP's business listed under Items 1 through 11 of Article 3(1) of the JLP Law, which are summarized as follows:

(1) acquisition and holding of stocks issued by a domestic company upon its establishment;
(2) acquisition and holding of stocks or warrants issued by an already existing company;
(3) acquisition and holding of certain kinds of securities under the SEL that the Enforcement Order of the JLP Law designates as helpful to finance a business entity; a business entity is defined to mean either an individual conducting business or a Japanese corporation;
(4) acquisition and holding of cash receivables from a business entity and acquisition and holding of cash receivables owned by a business entity;
(5) making new loans to a business entity;
(6) acquisition and holding of equity interests in a TK agreement or a trust agreement with a business entity;
(7) acquisition and holding of industrial property or copyrights owned by a business entity;
(8) provision of management-related advice or technical guidance to a business entity in which the relevant JLP itself has made investments using any of the

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foregoing methods;

(9) investment in another JLP or a domestic partnership conducting investment business, or in a foreign organization similar to the domestic partnership;

(10) business activities ancillary to the business described in the preceding items as prescribed by the Enforcement Order of the JLP Law (which includes acquisition and holding of promissory notes issued or held by a business entity, acquisition and holding of CDs, and trading of property provided as collateral to secure promissory notes and certain other types of debt); and

(11) acquisition and holding of stocks, warrants or securities prescribed in item (3) above issued by a foreign corporation, or equity interests in a foreign company, or interests similar to the foregoing, provided that the acquisition is made using an aggregate amount less than 50% of the total capital contribution of all partners. The Financial Services Agency of Japan's position is that, in the case of an offshore limited partnership, this 50% restriction on foreign companies does not apply.

Although the scope of the foregoing business categories is quite broad, the current definition of *securities* requires a business purpose. The FIEL, on the other hand, abandons the business purpose limitation and adopts a comprehensive definition of collective investment schemes as part of the securities definition. By broadly encompassing partnership and other vehicles (Article 2(2), item 5 covering rights under partnership agreements under Japanese law, and item 6 covering those under non-Japanese law), this definition deems interests in such vehicles to be securities. Such securities are generally called *deemed securities*, as opposed to traditional securities typically used for frequent trades. A partnership agreement is generally encompassed by the new definition if it entitles an investor to distributions of profits generated from, or distributions of properties in relation to, the business to which an investor has contributed money or certain other types of assets. An exception to this definition applies where, among other things: (i) all the investors are involved in the business in the manner to be provided in the relevant Cabinet Order; or (ii) there are no distributions of profits or properties to investors over the originally invested amount. This means that any passive investment agreement (other than covered by any other item of the securities definition) would generally be captured by the definition of a *collective investment scheme*, regardless of the form of vehicle, and the rights under the agreement would be deemed securities under the FIEL.

This expansion of the securities definition can be viewed as an introduction of the Howey test under the US securities law. The traditional structure of the SEL in relation to the definition of securities is an enumeration method in which the rights or instruments that fall under the definition constitute an exhaustive list. The addition of the definition of collective investment schemes is open-ended and, like the

Howey test, would enhance investor protection.

Definition of security under US Federal law

Section 2(a)(1) of the Securities Act of 1933, and the judicial interpretation of this Section, constitute the primary sources of law for what constitutes a security. Section 2(a)(1) of the Securities Act reads as follows:

"(a) When used in this title, unless the context otherwise requires,

(1) The term "security" means any... investment contract,... or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

(Because, according to the Supreme Court in *Tcherepnin v Knight* (1967), the definition of a security in Section 3(a)(10) of the Securities Exchange Act is almost identical to that of the Securities Act, most questions relating to what constitutes a security under the Exchange Act could be answered by reference to the same language under the Securities Act.)

Three issues arise from this definition. First, a security will exist if found to fall under any of the expressly enumerated bases of Section 2(a)(1) of the Securities Act. Second, the term *investment contract* is not clearly defined. The courts, in determining whether or not a partnership structure gives rise to a security as defined under the Securities Act, have generally relied upon the basis of an investment contract, and not on other bases enumerated under Section 2(a)(1). (See, for example, *Steinhardt Group v Citicorp* (1997), *SEC v Shreveport Wireless Cable TV Pshp* (1998), *SEC v Telecom Mktg* (1995) and *Deckebach v La Vida Charters* (1987)). Third, the definition above makes a distinction between a specific instrument as a security and a "certificate of interest or participation in... any of the foregoing." So it is conceivable that, where a limited partnership would be involved with a particular investment (non-performing loans, for example), the underlying investment might not fall under the definition of a security, but the seller (or offeror, as the case may be) of the participation in the limited partnership might be found to be issuing a security. This article focuses on a security that would be created by virtue of the sale of the participation in the relevant Japanese partnership (on the assumption that the Securities Act would be triggered at all by virtue of a legitimate offer an sale having been made).

The expansion of the securities definition can be viewed as an introduction of the Howey test under the US securities law

In *SEC v Howey Co* (1946) the US Federal Supreme Court poured content into the meaning of *investment contract* in holding that "the test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." Accordingly, to constitute a security within the meaning of the Securities Act, all of the following are required: (a) an investment of money; (b) a common enterprise; (c) profits; and (d) the profits derived solely from the efforts of others.

Howey test: an investment of money

The courts have generally held that an investment for something other than profit or financial gain is not a security. See, for example, *United Hous Found Inc v Forman* (1975), wherein the court held, on the facts in issue, that an investment by certain investors in a certain cooperative housing project was an investment in acquiring a place to live, and not in financial returns. Also, notwithstanding that the Howey test requires an investment in money, courts have not limited the consideration to money. This is because "the Securities Act covers all offers and sales of securities, regardless of the form of consideration to be exchanged in the bargain."

Howey test: a common enterprise

Depending upon which circuit the issue of the determination of a common enterprise is tried under, the court will adopt one of the following three approaches: the horizontal approach, the narrow vertical approach or the broad vertical approach. (See Borneman, Ryan, *Why the Common Enterprise Test Lacks a Common Definition* (2005).) Under the horizontal approach, a common enterprise will be found if the court finds on the facts a pooling of investors' monies in a business enterprise, resulting in the investors sharing all the risks and benefits of the enterprise. Conversely, under the narrow vertical approach, a common enterprise will be found if "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment." Under the broad vertical approach, a common enterprise will be found if the investor depends upon the expertise and efforts of the promoter for its returns (*Sec & Exch Comm'n v ETS Payphones Inc* (2002)).

Howey test: profits

To be caught under the Securities

Act as a security, there must be an investment for profit or financial gain. The facts in *SEC v Edwards* (2004) were that investors invested in a scheme with a fixed annual return (at a specified percentage). The 11th Circuit held that an offer requires either capital appreciation or a participation in the earnings enterprise to satisfy the profits prong of the Howey test. The Supreme Court, however, overruled the 11th Circuit and stated that:

"There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood. In both cases, the investing public is attracted by representations of investment income. Moreover, investments pitched as low risk (such as those offering a 'guaranteed' fixed return) are particularly attractive to individuals more vulnerable to investment fraud, including older and less sophisticated investors."

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Howey Test: profits solely from the efforts of others

If all above thresholds have been met, a security will be found to exist if profits are derived solely from the efforts of others. The difficulty that arises is that if the profits are derived solely (or exclusively) from others, a serious loophole would exist in the Securities Act, and allow persons to escape the fraud provisions merely by requiring a minimal effort on the part of investors (*SEC v Glenn W Turner Enters*). As a result, courts have either read out or explained away the *solely* qualification, and have determined this prong of the Howey test to be satisfied if the investment was based upon the efforts of others.

Efforts of others, however, has been interpreted in many ways over the years, and some confusion still exists over its precise meaning. Generally, regardless of the form of the partnership (that is, any of the Japan investment vehicles discussed above), the rule is that courts will find this prong of the Howey test met if the partner is a passive investor:

"The ultimate determination will depend on the ways in which the partnership interests are marketed to investors. If it is contemplated that the partners will play a passive role while the business is managed by someone else, then the securities laws are likely to be implicated. Even where a partner has enough of an ownership interest to have an input in the day to day business operations, a decision by that partner to remain passive will not negate the inference that the partnership interest is a security" (Hazen, Thomas Lee, *The Law of Securities Regulation* (2005)).

In another seminal case, the court in *Hawaii v Hawaii Market Centre Inc* (1971) developed a risk capital test to determine whether or not a security exists. A security under this test will be found to exist if: "(a) the investor provides initial value to the enterprise, (b) the initial value is subject to the risk of the enterprise, (c) the initial value is induced by representations leading to a reasonable understanding that the investor will realize a valuable benefit beyond the initial value, and (d) the investor does not exercise managerial control over the enterprise." The risk capital test effectively broadens the definition of security because, among other things, it does not include a *common enterprise* requirement, as does the Howey test.

The Howey test is used in the federal courts and in most state courts, and the risk capital test is used in only a minority of state courts. (See further, Pease, Gregory J, *Bluer Skies in Tennessee – The Recent Broadening of the Definition of Investment Contract as a Security and an Argument for a Unified Federal-State Definition of Investment Contract* (2004).)

Financial instruments business registration

Another challenge for investment funds under the FIEL is the registration requirement as a financial instruments business firm. Under the old regime, general partners (or other operating entities) of partnerships mentioned above were generally not required to register as a securities company under the SEL despite the fact that they solicited investors to purchase their interests that constitute securities. This was based on the interpretation that the issuer's solicitation of its own securities was not a securities business. Nor were general partners required to register as investment advisers under Japan's Law Concerning Regulations of Investment Advisory Business Related to Securities (Law 74 of 1986, as amended; the Investment Advisory Law) on the theory that general partners only manage their own assets jointly with others, notwithstanding that they essentially do manage assets on behalf of limited partners.

The FIEL has merged the Investment Advisory Law, which will be abolished when the FIEL takes effect. Under the new law, securities companies and investment

advisers under the current regime will be referred to as financial instruments business firms and are required to registered as such. If a general partner: (i) solicits interests in its own fund; and (ii) invests in securities or derivatives, investment management of the assets of its own fund would fall under the definition of financial instruments business, and so would generally require the general partner to register as a financial instruments business firm (Article 2(8), Items 7 and 15 of the FIEL). There are four categories of *financial instruments business*: (i) first financial instruments business; (ii) investment management business; (iii) second financial instruments business; and (iv) investment advisory and agency business. A general partner's solicitation of its own fund interests falls within category (iii) and investment management of the assets of its own fund falls within category (ii). Category (i) is meant to cover, among other things, traditional securities broker-dealer business. So-called non-discretionary investment advisory business is included in category (iv). This can be viewed as equivalent to: (i) broker-dealer registration under Section 15 of the US Securities Exchange Act of 1934; and (ii) investment adviser registration under Section 203 of the US Investment Advisers Act of 1940, as covered by a single registration.

Another challenge for investment funds under the FIEL is the registration requirement as a financial instruments business firm

This onerous registration requirement is eased to a notice filing requirement if the partnership falls under an exemption. An exemption is generally available where, with respect to solicitation of interests as mentioned in (i) above, the offering is made on a private basis only to qualified institutional investors plus a certain limited number of investors, and where, with respect to investment management of the fund assets as mentioned in (ii) above, the fund is held only by qualified institutional investors plus a certain limited number of investors. This *certain limited number of investors* will be designated by cabinet order. The number is expected to be 49 or less.

Comparing the two approaches

The four prongs of the Howey test ((a) an investment of money; (b) a common enterprise; (c) profits; and (d) profits being solely from the efforts of others), the test that US courts would employ in determining whether a security within the definition an *investment contract* under Section 2(a)(1) of the Securities Act has been created, are generally contained in the elements of a collective investment scheme under the FIEL. In relation to item (a), the FIEL requires a contribution of money or certain other types of assets. While item (b) is not clear in the context of the FIEL, a collective investment scheme does require the existence of a business to which at least one investor makes a contribution. Items (c) and (d) correspond to the exceptions mentioned above; interests in a partnership will not be deemed securities if: (i) all the investors are involved in the business in the manner to be provided in the relevant cabinet order; or (ii) there are no distributions of profits or properties to investors in excess of the originally invested amount. On the other hand, Japan's approach regarding the financial instruments business registration indicates that Japan's new securities regulations might, in some respects, be taking an approach different from US securities law.

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