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Alternative Funds

Japan: Law and Practice

Keiko Shimizu, Koichiro Yoshimura
and David Azcue

Nagashima Ohno & Tsunematsu
and Simpson Thacher & Bartlett LLP

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Law and Practice

Contributed by:

Keiko Shimizu, Koichiro Yoshimura and David Azcue
 Nagashima Ohno & Tsunematsu
 and Simpson Thacher & Bartlett LLP see p.15



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1. General

1.1 General Overview of Jurisdiction

Japan is the world's third largest economy by GDP and has sophisticated and well-developed debt and equity capital markets, with many leading global corporations. However, outside of the real estate sector, Japanese private funds have generally lagged behind other regions including, in particular, North America and Europe, from both a transactional and fundraising perspective. According to M&A advisory services firm, RECOF, M&A penetration relative to GDP has hovered near 2% in Japan in recent years, compared to 9–10% in the United States and the United Kingdom, and outside of real estate and infrastructure, average fund sizes tend to be quite small (approximately USD270 million in 2019, according to Asia Private Equity Review – APER). Japan-domiciled hedge funds are very uncommon, with industry tracker eVestment reporting that less than 1% of all hedge funds globally have their primary physical location in Japan. Real estate is the main exception, where Japan ranks second only to the United States in Morgan Stanley Capital International's (MSCI) estimated share of the global professionally managed real estate investment market.

Although generally smaller than in North American and Europe, alternative private funds are active, growing and becoming an increasingly important part of finance in Japan. According to Deloitte, at least 170 private equity firms are now active in Japan, with many global firms focusing on larger corporate carve-out transactions, and a burgeoning domestic industry focusing on small and mid-cap deals, playing a vital role in founder successions.

2. Funds

2.1 Types of Alternative Funds

There is a wide range of alternative funds established in Japan. The main fund structures are summarised in **2.2 Fund Structures**. (Note that retail funds and investment trusts are not discussed, as they are beyond the scope of this chapter.) By class, real estate and private equity are most common, with an increasing number of venture capital funds, and increasing amounts of capital raised by infrastructure funds. Conversely, domestic hedge funds are not particularly prevalent.

2.2 Fund Structures

For legal, regulatory and tax reasons, different fund structures are used for different types of alternative funds. This section outlines six of the most common domestic structures and discusses their applicability with respect to different strategies.

Investment Business Limited Partnerships (Toshi Jigyo Yugen Sekinin Kumiai)

The Investment Business Limited Partnership Act permits funds to be formed as investment business limited partnerships (IBLPs), with a general partner that manages the fund and limited partners having limited liability. The IBLP has become a common domestic entity used by alternative funds, particularly in the private equity, venture capital spaces, and in some cases, for infrastructure funds. The use of the IBLP structure is limited, however, due to restrictions on the types of assets in which an IBLP fund is permitted to invest. In particular, subject to certain limited exceptions, an IBLP may not invest 50% or more of its assets in non-Japanese securities, making the IBLP relatively unsuitable for funds that invest substantial portions of their capital outside of Japan. Additionally, IBLPs may present complexities for non-Japanese investors, including potential Japanese tax issues (discussed below). As offshore fund structures can generally be used for investments in Japanese assets, it is not uncommon for Cayman Islands exempted limited partnerships (ELPs) and similar offshore vehicles to be used for alternative funds that invest in Japan.

General Partnerships (Nin'i Kumiai)

A general partnership (*nin'i kumiai* or NK) may be used when an IBLP is unsuitable, eg, due to the asset class restrictions mentioned above. An NK can be managed in a manner similar to an IBLP, by appointing an executive partner who will manage the NK, but all the partners, including those that may have only passive roles, will have unlimited liability.

GK-TK Structures

A GK-TK is a structure unique to Japan that is often used for making domestic real estate and infrastructure investments. In essence, a *godo kaisha* (GK), which is a form of limited liability company that acts as a property-holding company, enters into a bilateral contract, called a *tokumei kumiai* agreement (TK agreement), with the investor (TK investor). Pursuant to the TK agreement, the TK investor makes a commitment to contribute capital to the GK, to be used for the GK's investment activities (as set forth in the TK Agreement) in exchange for profit rights with respect to such activities. In a GK-TK structure, only the GK is permitted to take an active role in the management of the GK.

Although more commonly used as an investment acquisition structure, the GK-TK structure may also be used as an aggregating arrangement for multiple TK investors, effectively creating a fund-like collective investment scheme. In such a case, while the TK agreements remain bilateral contracts between the TK investor and the GK, certain rights may be conditioned upon the collective actions of other TK investors, thereby providing for governance and co-ordination among the TK investors in a

manner similar to more common alternative fund arrangements (eg, by providing for removal of the GK, a key-person event, conflict of interest protections, synchronisation of drawdowns and distributions, etc). Despite the creation of a partnership-like relationship for the TK investors with respect to the GK, the GK-TK itself is a contractual arrangement and there is no actual legal GK-TK entity.

TMK (Tokutei Mokuteki Kaisha)

A *tokutei mokuteki kaisha* (TMK), literally a special purpose company, is a form of limited liability company established under the Act Concerning Asset Liquidation. It is used exclusively for the securitisation of assets and is often used as a vehicle for investment in real estate. Property rights can be securitised via a TMK through the issuance of asset-backed securities to investors, usually in the form of equities or bonds.

J-REITs

Japanese REITs (J-REITs) are established as investment corporations under the Act on Investment Trusts and Investment Corporations. Many J-REITs are listed and publicly traded in Japan, although an increasing number of J-REITs are private. The rules and regulations applicable to the formation and management of J-REITs are significantly more complex and onerous than those applicable to the other fund structures discussed above.

Investment Trusts (Toshi Shintaku)

Investment trusts are established under the Act on Investment Trusts and Corporations. They are a popular form of investment fund for both retail and institutional investors, but as noted above, are beyond the scope of this chapter and are therefore not discussed in detail.

2.3 Regulatory Regime

In Japan, the regulatory regime applicable to an alternative fund depends in the first instance on the organisational structure of the fund – primarily, whether the fund is organised as a partnership, corporate or other entity form.

Partnership-Type Alternative Funds

For partnership-like entities, including IBLPs, foreign partnerships, NKs and GK-TKs (referred to collectively here as “funds”), the relevant regulatory regime will generally be the Financial Instruments and Exchange Act of Japan (FIEA), which sets forth the rules applicable to both the offering of securities and regulation of the managers of the relevant fund. The FIEA is generally applicable where an investor in a fund or the fund’s manager is located in Japan. This section considers the FIEA regulations applicable to marketing and investment management separately.

Marketing regulations

As a general rule, if a general partner of a partnership, including an IBLP or a foreign partnership (or a person acting in a similar capacity in a partnership-type fund such as a GK in a GK-TK structure, which is referred to collectively here and in **4.2 Marketing of Alternative Funds** and **4.5 Regulatory Regime** as a “general partner”), solicits investors in Japan, the general partner must generally either be registered as a financial instruments business operator engaged in Type II financial instruments business under the FIEA (ie, hold a Type II licence) or perfect an exemption from registration for this. Alternatively, it may be possible for the general partner to solicit investors in Japan without a Type II licence if the general partner delegates all solicitation activities relating to the fund to a third party holding a Type II licence. In such cases, the general partner must not itself engage in any solicitation relating to the fund.

QII Exemption (for marketing)

One of the most common exemptions from the registration requirement in connection with marketing interests in a partnership-like fund under the FIEA is the special business exemption for qualified institutional investors (QII Exemption). The QII Exemption is available to qualified general partners where the fund’s partners include at least one qualified institutional investor (QII) solicited in Japan and 49 or fewer non-QIIs that meet certain statutory qualifications (ie, non-QII qualified purchasers). If a general partner qualifies for the QII Exemption, it must make an Article 63 notice filing on Form 20 (Article 63 Notice) with the applicable Local Finance Bureau prior to having a closing with the investors who are solicited in Japan. Certain transfer restrictions and asset segregation requirements will apply, and the general partner will be subject to certain other requirements, including the requirement for a non-Japanese general partner to appoint a local representative in Japan, compliance with certain code of conduct rules and disclosure requirements, and certain record-keeping obligations.

Investment management regulations

In addition to marketing regulations, a partnership-type fund will also need to comply with certain investment management regulations under the FIEA. To the extent that the fund will invest mainly in securities and/or derivatives, the general partner will need to register as a financial instruments business operator engaged in investment management business under the FIEA (ie, an “investment manager” registration).

QII Exemption (for investment management)

Helpfully, the QII Exemption discussed above with respect to marketing is also generally available with respect to investment management requirements. There are some slight differences in the requirements for the QII Exemption for the purposes of investment management regulations compared to the exemp-

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Nagashima Ohno & Tsunematsu and Simpson Thacher & Bartlett LLP*

tion for marketing, including the absence of transfer restrictions and additional ongoing compliance obligations, but otherwise the exemptions are fairly similar. By filing an Article 63 Notice, the general partner will be exempt from registration as an investment manager under the FIEA.

De minimis exemption

An alternative exemption from the investment manager regulations under the FIEA, which is available solely for funds established outside Japan, is the so-called “de minimis exemption” (also sometimes referred to as the “foreign funds exemption”). This exemption is available when:

- the fund’s direct investors in Japan (Japanese direct investors) are limited to QIIs and persons who have submitted an Article 63 Notice with respect to the investment management of the fund;
- the fund’s indirect investors, who invest through partnerships formed under Japanese law (indirect investors), are limited to QIIs;
- the fund has fewer than 10 investors who are either Japanese direct investors or indirect investors resident in Japan; and
- aggregate contributions from the fund’s Japanese direct investors make up one third or less of the aggregate contributions to the fund from all investors.

For the purposes of the de minimis exemption, an investor will be deemed to be a “direct Japanese investor” if the investor is a resident of Japan and directly holds its interest in the foreign fund, and will be considered an “indirect Japanese investor” if the investor is a resident of Japan and holds its interest in the foreign fund indirectly through a partnership-type entity formed under Japanese law (eg, an IBLP, NK or GK-TK).

Additional regulations, including regulations under the Act on Specified Joint Real Estate Ventures and/or the Act on Regulation of Commodity Investment, may also apply depending on the type of investments made by the fund.

Regulations Applicable to TMKs, J-REITs and Investment Trusts

Marketing regulations

Marketing of interests in a TMK, a J-REIT or an investment trust, may only be made by persons who either hold a Type I financial instruments business operator licence or satisfy an available exemption.

Separate and apart from the registration requirements for the person who engages in the marketing of the relevant interests, unless the offering qualifies under an applicable private placement exemption, the offering will be considered a public offering, and will therefore require the filing of a securities regis-

tration statement as well as additional requirements under the FIEA. Two private placement exemptions are available:

- a private placement for a small number of investors; and
- a private placement for QIIs.

The requirements for such exemptions differ depending on the type of interest.

Investment management regulations

Under the applicable law, investment management of a J-REIT must be delegated to an investment manager registered under the FIEA, and investment trusts may only be established by an investment manager registered under the FIEA to engage in investment trust management business. There are additional rules and regulations that apply to investment management of J-REIT and investment trusts.

Investment decisions for TMKs may be made by the TMK itself, based on investment advice from a registered investment adviser. Alternatively, the TMK may delegate investment management to an investment manager registered under the FIEA.

2.4 Loan Origination

It is technically possible to originate loans in Japan if the funds comply with applicable laws, rules and regulations. Direct lending to any person in Japan is generally regulated under the Money Lending Business Act and requires that money lenders be registered thereunder. These regulations are also applicable to alternative funds and, depending on the legal structure of the alternative fund, the fund or its general partner will usually need to be licensed as a money lender in order to originate loans to a person in Japan, if the lending activities are considered to take place in Japan and lending is considered to be conducted as a business.

In determining whether lending activities take place in Japan, the applicable facts and circumstances would be taken into consideration, including factors such as the location of the lender and the borrower, where the loan agreement is negotiated and executed, and the location of the bank accounts from which the money is sent and received.

There are limited exemptions from the requirement to register as a money lender, and if an alternative investment fund holds 50% or more of voting rights in a Japanese portfolio company, direct lending to such portfolio company is exempt from this registration requirement.

2.5 Cryptocurrencies and Non-traditional Assets

IBLPs are subject to assets class restrictions under which they are not permitted to invest in cryptocurrency assets. Such

restrictions are not, however, applicable to NKs or GK-TK structures, subject to compliance with other applicable requirements under the FIEA.

J-REITs and investment trusts are also subject to assets class restrictions and may not invest in cryptocurrency assets.

2.6 Regulatory Approval Process

As discussed in **2.3 Regulatory Regime**, generally where funds are structured as partnerships, the fund operator would make an Article 63 Notice filing with respect to marketing and/or investment management, subject to the application of other exemptions from registration requirements. No regulatory approval is required to make an Article 63 Notice filing, although the Japanese regulators will review the Article 63 Notice and request that revisions be made to the filing if they consider such revisions necessary.

A TMK can be established without regulatory approval, but it must be established under the Act on Securitisation of Assets and a business commencement notification must be filed pursuant to this. Pre-review procedures are not required.

J-REITs can usually be established as investment corporations under the Act Concerning Investment Trusts and Investment Corporations. If the investment manager is newly established with the J-REIT, the investment manager will be required to obtain certain licences and registrations prior to the establishment of the investment corporation. The time required to complete the process varies and may take anywhere from several months to over a year.

2.7 Requirement for Local Investment Managers

For IBLPs, the general partner must be a domestic entity. If the general partner delegates investment management in securities or derivatives to an investment manager, such investment manager must be a registered investment manager under the FIEA. A non-Japanese entity can be registered as an investment manager under the FIEA, but must have an office in Japan.

For NKs, there is no requirement for the executive partner to be a Japanese entity or person. For a GK-TK structure, as discussed in **2.2 Fund Structures**, the GK is typically a Japanese limited liability company, although it is possible, though rare, for a non-Japanese entity to enter into a TK agreement with an investor. However, as with IBLPs, if investment management in securities or derivatives is delegated to an investment manager, the investment management must be registered under the FIEA.

An investment manager or investment adviser to a TMK must be registered as an investment manager or investment adviser under the FIEA. For J-REITs and investment trusts, as discussed

in **2.6 Regulatory Approval Process**, the investment manager must be registered in this capacity under the FIEA.

2.8 Other Local Requirements

While there is no particular local substance rule other than as discussed in **2.7 Requirement for Local Investment Managers**, Japanese alternative fund vehicles are generally established and managed by local entities.

2.9 Rules Concerning Other Service Providers

There are no specific rules applicable to service providers of IBLPs, NKs or GK-TK structures, or the operators of such fund vehicles, other than the requirement regarding delegation of investment management as discussed in **2.7 Requirement for Local Investment Managers**.

As J-REITs and investment trusts are strictly regulated, service providers need to meet certain requirements under the Act on Investment Trusts and Investment Corporations.

2.10 Requirements for Non-local Service Providers

Generally, if services that are regulated under Japanese law are provided to Japanese funds or fund operators, Japanese laws and regulations would apply. However, other than as discussed in **2.7 Requirement for Local Investment Managers** and **2.9 Rules Concerning Other Service Providers**, customary services provided by administrators, custodians and director services providers are generally not regulated in Japan.

2.11 Tax Regime

Taxation of Alternative Funds Established in Japan

Japan is a relatively high-tax jurisdiction and an important consideration for non-Japanese investors investing in alternative funds in Japan is ensuring that the structure is tax optimal, so as to minimise the exposure of non-Japanese investors in connection with their Japanese investments through such alternative funds.

Under applicable Japanese tax laws, non-Japanese resident investors without a permanent establishment in Japan (Offshore Investors) are generally not subject to tax on capital gains from the sale of shares of a Japanese company, unless certain enumerated exceptions apply. There are three main exceptions that are relevant to Offshore Investors:

- being deemed to have a permanent establishment in Japan (eg, by virtue of being a partner in a fund vehicle that itself has a permanent establishment in Japan);
- becoming subject to the so-called “25/5 Rule” by owning, or being deemed to own, 25% or more of the shares of the Japanese company during an applicable holding period in

which the Offshore Investor sells, or is deemed to have sold, 5% or more of such company's shares; or

- becoming subject to the so-called "Real Estate Holding Company Rule", by owning, or being deemed to own, more than 2% of the shares of the Japanese company (or more than 5% of shares, if the company is listed on an exchange), the value of which is predominantly derived, directly or indirectly, from real estate in Japan, on the day preceding the first day of the fiscal year in which the Offshore Investor sells, or is deemed to have sold, all or part of such company's shares.

In addition to capital gains, certain types of income (eg, dividends, interest and distribution under a TK agreement) derived by the Offshore Investors will be subject to withholding tax at varying rates. Both capital gains and other income may be subject to reduction or exemption under applicable tax treaties as discussed in **2.12 Double-Tax Treaties**.

These tax consequences for Offshore Investors vary depending on the type of vehicle used by the alternative fund, as summarised below. See **4.7 Tax Regime** for taxation of investors in Japan.

Tax treatment of NKs

An NK is transparent for Japanese tax purposes and, as such, each partner in an NK is viewed as earning its allocated share of income derived by the NK. However, since the NK is typically managed in Japan and has one or more partners that are resident in Japan, there is generally a high risk that Offshore Investors in an NK will be deemed to have a permanent establishment in Japan. This is because the Japanese tax authority takes the position that if even a single partner in an NK has a permanent establishment in Japan, then all of the Offshore Investors in the NK are deemed to have a permanent establishment, based on the view that an NK's business is operated jointly by all partners. Unlike in the case of an investment made through an IBLP (discussed below), no statutory exemption is available to permit Offshore Investors in an NK to be exempted from being deemed to have a permanent establishment in Japan.

If an Offshore Investor investing through the NK is deemed to have a permanent establishment in relation to the business of the NK, the NK will be subject to withholding on distributions of the partnership profits to such partners at a rate of 20.42%. A non-resident partner who is deemed to have a permanent establishment in Japan will be required to file a tax return to report its share of income from the NK. This makes an NK relatively unsuited for use by Offshore Investors for Japan-focused investments.

Tax treatment of IBLPs

An IBLP is treated as being transparent for Japanese tax purposes and, as such, each partner in an IBLP is viewed as earning its allocated share of income derived from the IBLP. As mentioned above, while Offshore Investors are generally not subject to tax on capital gains from the sale of shares of a Japanese company, there are three exceptions under which their capital gains become subject to tax. Since it is uncommon to use an IBLP for investment in real estate (see **2.2 Fund Structures**, regarding restrictions on the types of assets in which an IBLP is permitted to invest), the other two exceptions are discussed below.

Permanent establishment (PE)

The Japanese tax authority's position discussed above with respect to NKs applies equally to an IBLP. As such, in the absence of an available exemption (discussed below), an Offshore Investor will be deemed to have a permanent establishment in Japan if it invests in an IBLP, a partner of which has a permanent establishment in Japan (eg, if its managing entity conducts business in Japan).

In contrast to an IBLP, if a fund is established as a legal entity outside Japan and is not managed in Japan, it may be possible to structure the fund so that it does not cause Offshore Investors to be deemed to have a permanent establishment in Japan. As the analysis is complex, sponsors and Offshore Investors should discuss the tax implications of an investment in a fund organised as a non-Japanese legal entity carefully with their Japan tax advisers.

PE exemption filings

Pursuant to a proposal by the Japanese Ministry of Economy Trade and Industry (METI) intended to facilitate investment in Japanese alternative funds by Offshore Investors, the 2009 annual tax reforms introduced a safe harbour that permits Offshore Investors to invest through such funds notwithstanding the fact that they may be deemed to have a permanent establishment in Japan. To take advantage of the safe harbour, the Offshore Investors are required to make a filing to perfect the exemption. In order to qualify for the exemption, the Offshore Investor must:

- be a limited partner in the fund;
- not be deemed to take part in certain aspects of the management or operation of the fund;
- itself own less than a 25% share of the assets of the fund;
- have no special relationship to the general partner of the fund; and
- not otherwise have a permanent establishment in Japan.

Three factors limit the use of the PE exemption filing (and the 25/5 Rule exemption filing discussed below) for Japan buyout funds:

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Nagashima Ohno & Tsunematsu and Simpson Thacher & Bartlett LLP*

- in order to be eligible for the exemption, Offshore Investors must not take part in the management of the fund, effectively requiring such investors seeking the benefit of the safe harbour to waive certain governance, oversight and consent rights (eg, participation in an LP advisory commitment), which tend to be important to private fund investors;
- Offshore Investors relying on the filing would still be subject to the 25% limit (in the case of a 25/5 Rule exemption filing, without application of the aggregation principle discussed below), which could pose difficulties for smaller funds and/or funds with a concentrated investor base, such as co-investment funds, bespoke funds and fund-of-one arrangements; and
- sponsors and some investors may find the filing requirements to be burdensome, particularly fund of funds, which may be required to make such filings on behalf of their underlying investors, and other investors who find such filings to be intrusive.

The 25/5 Rule

Under the 25/5 Rule, an Offshore Investor will become subject to tax on capital gains from the sale of shares of a Japanese company, if the Offshore Investor owns, or is deemed to own, 25% or more of the shares of the underlying Japanese company during an applicable holding period in which the Offshore Investor sells, or is deemed to have sold, 5% or more of such company's shares. While an IBLP is treated as transparent for Japanese tax purposes, where the Offshore Investor invests through a fund structure as a pass-through partnership (eg, as an IBLP), an aggregation rule applies for the purposes of calculating the 25% and 5% thresholds under the 25/5 Rule. Under this aggregation rule, an Offshore Investor's holdings are aggregated with all of the Offshore Investor's "specially related shareholders", which are deemed to include all of the other partners in the fund in which the Offshore Investor invests. As with a permanent establishment, the analysis is complex, and sponsors and Offshore Investors should discuss the tax implications of an investment in a fund organised as a pass-through partnership carefully with their Japan tax advisers.

There are two safe harbours from capital gains taxation under the 25/5 Rule which may potentially be available for Offshore Investors investing through a fund structured as an IBLP: (1) a safe harbour perfected through a statutory exemption filing, and (2) reliance on treaty benefits under an applicable tax treaty.

25/5 Rule exemption filings

The 2009 annual tax reform that introduced the PE exemption safe harbour, also introduced a separate safe harbour to permit Offshore Investors to invest through such funds notwithstanding the fact that the fund in the aggregate owns or is deemed to own 25% or more of the shares of any underlying Japanese

portfolio company. To take advantage of the safe harbour, an Offshore Investor is required to make a filing to perfect the exemption. In order to qualify for the exemption, the Offshore Investor must:

- be a limited partner in the fund;
- not be deemed to take part in certain aspects of the management or operation of the fund; and
- itself own less than 25% of the shares of the underlying Japanese portfolio company in which the fund invests (without application of the aggregation principle under the 25/5 Rule).

This exemption does not apply if the relevant fund has held the shares for a period of less than one year at the time of sale. Note also that the limitations applicable with respect to PE exemption filings (discussed above) also apply to 25/5 Rule exemption filings.

Tax treaty benefits

Even if capital gains derived by the Offshore Investors become taxable under the 25/5 Rule, Offshore Investors may still be able to rely on an available tax treaty between Japan and the jurisdiction in which the Offshore Investor is considered to be resident under such tax treaty. This is discussed in more detail in **2.12 Double-Tax Treaties**.

Tax treatment of GK-TK structures

A GK itself is opaque for Japanese tax purposes and the GK is therefore required to file a tax return to report its income each fiscal year. However, under a GK-TK structure, profits allocated to the TK investors are deductible in calculating the taxable corporate income of the GK, and such profits would therefore be subject to tax only once at the level of TK investors, not at the level of the GK. A GK conducting its business in Japan will have withholding tax obligations for the distribution of its profits to TK investors at a rate of 20.42%.

Tax treatment of TMKs

A TMK is opaque for Japanese tax purposes and is therefore required to file a tax return to report its income each fiscal year. However, dividends paid out to its investors are deductible in calculating the taxable corporate income of the TMK, subject to the TMK satisfying certain conditions, including a requirement to distribute as dividends more than 90% of the distributable profits of the TMK in the same fiscal year. As long as all such conditions are met, profits earned and paid out as dividends by a TMK would be subject to tax only once at the level of its investors, but not at the level of the TMK itself. A TMK will have a withholding tax obligation for dividends at a rate of 20.42%. Non-resident investors in a TMK may, depending on its particu-

lar circumstances, be required to file tax returns to report capital gains from alienation of their interest in the TMK.

Tax treatment of the investment corporation of a J-REIT

The investment corporation of a J-REIT is itself opaque for Japanese tax purposes and therefore required to file a tax return to report its income each fiscal year. However, as with a TMK, dividends paid out to its investors are deductible in calculating the taxable corporate income of the investment corporation if the investment corporation meets certain conditions, including a requirement to distribute as dividends more than 90% of the distributable profits of the investment corporation in the same fiscal year. As long as all such conditions are met, profits earned and paid out as dividends by the investment corporation will be subject to tax only once at the level of its investors, but not at the level of the investment corporation itself. An investment corporation will have a withholding tax obligation for such dividends (applicable withholding tax rates differ depending on whether the investment corporation is listed on an exchange and whether the recipient is a corporate entity or individual). Non-resident investors in the investment corporation may, depending on its particular circumstances, be required to file tax returns to report capital gains from alienation of their interest in the investment corporation.

2.12 Double-Tax Treaties

Japan has an extensive double-tax treaty network, and the Japanese government is actively seeking to expand it further. Not every jurisdiction has a tax treaty with Japan, however, and the benefits may vary significantly between jurisdictions, so any investor seeking to invest in Japan while relying on tax treaty benefits, should consult with its own tax adviser to understand whether and to what extent such benefits may be available. Whether alternative funds established in Japan qualify for benefits under an applicable double-tax treaty generally depends on whether the relevant vehicle used for such funds is transparent or opaque for Japanese tax purposes, as explained below. It should be noted, however, that where an alternative fund established in Japan derives income from a foreign jurisdiction (Source Jurisdiction), whether such fund would be entitled to benefits under the applicable double-tax treaty for such income is ultimately a question of tax law in the Source Jurisdiction (including interpretation of the treaty in that jurisdiction).

Where the Vehicle Used for the Alternative Fund is Opaque for Japanese Tax Purposes

Depending on the terms of the double-tax treaty between Japan and the Source Jurisdiction, the fund may qualify for benefits under such treaty (eg, reduction in or exemption of withholding tax in the Source Jurisdiction).

Where the Vehicle Used for the Alternative Fund is Transparent for Japanese Tax Purposes

The fund itself would not generally qualify for benefits under the double-tax treaty between Japan and the Source Jurisdiction. Investors in the fund may, however, qualify for benefits under the double-tax treaty between the jurisdiction of their residence and the Source Jurisdiction, depending on the terms of such treaty.

2.13 Use of Subsidiaries for Investment Purposes

It is common for alternative funds (particularly private equity funds, real estate funds and infrastructure funds) to use subsidiaries for investment purposes. The primary reasons for use of subsidiaries are, among other reasons, to take advantage of debt-to-equity leverage at the subsidiary level and to segregate liabilities within each investment.

2.14 Origin of Promoters/Sponsors of Alternative Funds

Generally speaking, blind-pool alternative funds established in Japan tend to be established predominantly by domestic sponsors. Some of the larger buyout funds that invest in Japan, whether as a Japan-focused, pan-regional or global investment strategy, are established in off-shore jurisdictions due to legal, tax and regulatory considerations. Such larger funds are most commonly established by North American or European sponsors.

For real estate and infrastructure funds, an offshore feeder fund is commonly established, with investors investing into the offshore feeder, which then invests in a GK-TK or TMK arrangement when investing in particular transactions. Sponsors of these funds are typically a mix of domestic and overseas players, where these firms are established and operate in multiple jurisdictions including Japan.

2.15 Origin of Investors in Alternative Funds

Subject to applicable international sanctions and other eligibility requirements, there are generally no restrictions on the domicile of investors investing in Japanese alternative funds. Japanese investors naturally make up a significant proportion of investors in Japanese alternative funds, but investors from many foreign jurisdictions commonly invest in these funds as well. Investors from Asia, Europe, North America, Oceania, and occasionally the Middle East and other jurisdictions are not uncommon.

2.16 Destination of Investments Made by Alternative Funds

Many Japanese alternative funds are formed to invest in Japan and, as noted in **2.2 Fund Structures** (eg, with respect to IBLPs), may in some cases be required to invest predominantly in Japan. Subject to applicable international sanctions, Japanese managers

and sponsors also invest globally, including in Asia, the United States, the Americas, Oceania and elsewhere.

2.17 Key Trends

Please refer to Trends and Developments for information on key trends.

2.18 Disclosure/Reporting Requirements

As discussed in 2.3 Regulatory Regime, if an offering falls under a public offering under the FIEA, securities registration requirements and other disclosure requirements apply.

Also, in addition to the requirement to provide sufficient information for the investor to make an investment decision, the following is required:

- a document which includes certain matters required under the FIEA, including an explanation of the fund structure, an outline of the terms of the fund, and disclosure of certain risks and fees that may be payable in connection with an investment in such alternative fund, which document should be provided prior to the investor signing a subscription agreement or similar agreement; and
- a document summarising the subscription by the investor may apply if the investor is not a professional investor (*tokutei toshika*) under the FIEA. Moreover, if an Article 63 Notice is filed by the general partner, the general partner will be required to:
 - (a) provide an investment management report if the investor is not a professional investor;
 - (b) make certain matters indicated in such Article 63 Notice publicly available;
 - (c) file an annual business report; and
 - (d) make certain matters included in the annual business report publicly available.

Additional reporting requirements are applicable to J-REITs and investment trusts.

2.19 Anticipated Changes

No substantial changes to the regulations relating to alternative funds are expected in the short term.

3. Managers

3.1 Legal Structures Used by Fund Managers

In the case of IBLPs, the general partner is often established as a joint stock company (*kabushiki kaisha* or KK under the Companies Act), a GK or an LLP. In the case of a GK-TK arrangement, the GK is a limited liability company (*godo kaisha*) established

under the Companies Act, but it is possible for an entity other than a GK to enter into a TK agreement with the investor.

To the extent that investment managers of J-REITs, investment trusts and TMKs are Japanese corporations, they would be KTs, as required under the FIEA. If a TMK is simply a client receiving investment advice, the investment adviser need not be a KK, as long as it is registered as an investment adviser under the FIEA.

3.2 Regulatory Regime

See 2.2 Fund Structures and 2.3 Regulatory Regime for the outline of the regulatory regime applicable to alternative fund managers. If investment management in securities and/or derivatives is delegated to an investment manager, the investment manager must be registered as such under the FIEA.

3.3 Tax Regime

Taxation of Alternative Fund Managers in Japan

In Japan, there is no special tax regime applicable to fund managers, whether alternative funds of otherwise, and tax treatment of management fees and carried interest received from the fund are determined in accordance with the general rules of Japanese tax law. In practice, managers of alternative fund are typically either:

- vehicles that are opaque for Japanese tax purposes (eg, a KK and a GK, if such vehicle is established in Japan); or
- vehicles that are transparent for Japanese tax purposes (eg, an NK, an IBLP or an LLP, if such vehicle is established in Japan).

In each case, individual managers receive their management fees and carried interest from such vehicle. Below is a tax summary of the treatment in each case.

Where the vehicle used for the alternative fund manager is opaque for Japanese tax purposes

Such vehicle is subject to corporation tax on the management fees and carried interest at the effective tax rate of approximately 30%. When such management fees and carried interest are further paid from such vehicle to individual managers who are officers or employees of such vehicle, such management fees and carried interest would be treated as “salary income” of such individual managers, since such remuneration is paid in consideration for services provided in their capacities as officers or employees of such vehicle. As a result, such remuneration would be subject to tax under progressive tax rates (up to a maximum rate of 55.945%). There is a deduction limitation rule for remuneration paid to officers, and under this rule, all or part of the remuneration paid to individual managers may not be deductible in the calculation of taxable corporate income of such vehicle, if individual managers are officers of such vehicle.

Where the vehicle used for the alternative fund manager is transparent for Japanese tax purposes

Management fees received by individual managers are viewed as remuneration paid in consideration for provision of their services. As a result, such remuneration would be treated as “business income” or “miscellaneous income” of such individual managers, both of which are subject to tax under progressive tax rates (up to a maximum rate of 55.945%). For tax treatment of carried interest allocated to individual managers, see 3.5 **Taxation of Carried Interest**.

3.4 Rules Concerning “Permanent Establishments”

In order to encourage foreign funds to invest in Japanese securities, the Financial Services Agency published guidelines for an “independent agent exemption” with respect to fund managers, in consultation with the Tax Bureau of the Ministry of Finance and the National Tax Agency. While these guidelines are not prepared specifically for alternative funds, it would not be unreasonable to refer to them in analysing any “agent permanent establishment” issues in the context of alternative funds.

Under the guidelines, when a foreign fund enters into a discretionary investment agreement with a domestic investment manager and the domestic investment manager conducts certain investment activities in Japan under the discretionary investment agreement on behalf of such fund, that domestic investment manager would be considered to be an “independent agent”, thereby not constituting an “agent permanent establishment” of such fund, if all of the following conditions are met:

- discretion delegated to the domestic investment manager is not so limited that such fund would be considered, in substance, to be directly conducting investment activities in Japan;
- the number of officers of the domestic investment manager who concurrently serve as officers or employees of the foreign general partner or foreign investment manager of the fund is less than half the total number of officers of the domestic investment manager;
- the amount of remuneration of the domestic investment manager is linked to the amount of the total assets to be invested under the discretionary investment agreement or the investment income, with the contributions of the relevant parties appropriately taken into account; and
- in cases where the domestic investment manager exclusively or almost exclusively deals with such fund, the domestic investment manager has the capacity to diversify its business or acquire other clients without fundamentally altering the way it conducts its business or losing economic rationality for its current business.

It is also possible for the Offshore Investors to rely on the PE exemption filing discussed in 2.11 **Tax Regime**.

3.5 Taxation of Carried Interest

In Japan, there is no special rule for taxation of carried interest and therefore its tax treatment is determined by applying the general rules of Japanese tax law.

Where the Vehicle Used for the Alternative Fund Manager is Opaque for Japanese Tax Purposes and Individual Managers Receive Carried Interest from Such Vehicle

Since it can be assumed that individual managers receive carried interest from such vehicle in consideration for their services provided in their capacities as officers or employees of such vehicle, carried interest can be expected to be treated as “salary income” of such individual managers, and would therefore be subject to tax under progressive tax rates, up to a maximum rate of 55.945% (see also 3.3 **Tax Regime**).

Where the Vehicle Used for the Alternative Fund Manager is Transparent for Japanese Tax Purposes and Individual Managers Receive Carried Interest from Such Vehicle

With respect to tax treatment of carried interest in this case, there are two different views. One view is that, as with management fees discussed in 3.3 **Tax Regime**, carried interest received by individual managers would be viewed as remuneration paid to them in consideration for their services and thus treated as “business income” or “miscellaneous income” of such individual managers, both of which are subject to tax under progressive tax rates (up to a maximum rate of 55.945%). The other view is that, since the vehicle is tax transparent, individual managers would be viewed as having directly earned their allocated shares of the income derived by the fund, and the character of such income at the fund level would be respected in determining tax treatment of carried interest at the level of individual managers. Under this view, where the source of carried interest is capital gains from alienation of securities by the fund, carried interest received by individual managers would also be treated as capital gains from alienation of securities, which are subject to tax at a flat rate of 20.315%.

There is no judicial precedent that provides clarification or other meaningful guidance on this point. At present it is therefore unclear which view would prevail in court should this issue be litigated, and the outcome may differ depending on the specific facts and circumstances of the case.

3.6 Outsourcing of Investment Functions/ Business Operations

Managers of alternative investment funds are permitted to appoint sub-advisers and delegate their investment management functions or outsource other operations of the funds to

third parties. To the extent that the fund documents permit such delegation or outsourcing, there are no particular laws or regulations that restrict or regulate such delegation or outsourcing, subject to the service provider holding appropriate licences and registrations, if the provision of such services requires any such licence or registration. For example, if the function of investment management in securities or derivatives is outsourced, such investment functions may only be delegated to an investment manager registered under the FIEA.

3.7 Local Substance Requirements

An investment manager registered under the FIEA is required to have an office in Japan and personnel capable of appropriately conducting the investment management business in compliance with the applicable laws and regulations.

See 2.7 **Requirement for Local Investment Managers** and 2.9 **Rules Concerning Other Service Providers** for requirements regarding the general partner of an IBLP or NK, or the TK operator of a TK.

3.8 Local Regulatory Requirements for Non-local Managers

When a non-local manager wishes to act as sub-manager in Japanese alternative fund schemes, such non-local manager will need to have the appropriate licence or registration under Japanese law, which differs depending on the assets in which the fund invests. Even if the ultimate investment target of the fund is not securities, if the fund nonetheless invests in securities, a sub-manager will need to be registered as an investment manager under the FIEA. See 3.7 **Local Substance Requirements** for those requirements applicable to registered investment managers.

See also 2.7 **Requirement for Local Investment Managers** to 2.9 **Rules Concerning Other Service Providers** with respect to the appointment of non-local managers.

4. Investors

4.1 Types of Investor in Alternative Funds

See 2.15 **Origin of Investors in Alternative Funds**.

4.2 Marketing of Alternative Funds

For IBLPs, NKs, GK-TKs and foreign partnerships, if the general partner chooses to rely on QII Exemption for marketing as discussed in 2.3 **Regulatory Regime**, which tends to be common in practice, an Article 63 Notice filing must be made. To qualify for the QII Exemption for marketing, a fund can be marketed to an unlimited number of QIIs and non-QIIs that satisfy certain criteria (in that they are qualified purchasers), but the

fund must have at least one QII and may not have more than 49 non-QII qualified purchasers who will commit to invest in it.

A different set of rules apply to marketing of J-REITs, investment trusts and TMKs. As discussed in 2.3 **Regulatory Regime**, there are two types of private placement exemptions available, ie, (i) the private placement for QIIs exemption, and (ii) the private placement to a small number of investors exemption. Funds can only be marketed to QIIs if the J-REIT, investment trust or the TMK relies on the private placement for QIIs exemption; for the private placement to a small number of investors exemption and public offerings, there is no restriction under the private placement exemption on the types of offerees to which the funds can be marketed, but the marketing cannot be made to more than 49 investors. Note that for the purposes of determining the number of investors in the case of J-REITs and TMKs, one counts the number of investors solicited, whereas for partnership-type funds, one counts the number of investors who subscribe for interests in the fund.

4.3 Rules Concerning Marketing of Alternative Funds

See 2.3 **Regulatory Regime**.

4.4 Local Investors

Subject to applicable marketing rules, local investors may invest in alternative funds established in Japan. However, if a partnership-type alternative fund relies on the QII Exemption for marketing and/or investment management, or a J-REIT, an investment trust or a TMK relies on one of the private placement exemptions, the types of investors that may invest in such alternative funds would be restricted.

4.5 Regulatory Regime

For partnerships-type funds, general partners that rely on the QII Exemption for marketing must make an Article 63 Notice filing prior to the first closing with any investor solicited in Japan. Certain conduct rules apply once an Article 63 Notice filing for marketing is made. These conduct rules include a duty of good faith, advertising regulations, prohibitions on providing false information, a principle of suitability and a requirement to segregate assets, some of which are not applicable if the investors are “professional investors.” Also, providing any kind of discount or benefit, as well as compensation for any loss, may also be prohibited and require careful legal analysis.

For marketing of J-REITs and TMKs, a different set of rules apply and marketing is typically conducted through a placement agent registered as a Type I financial instruments business operator. Unless marketing of interests is made by way of a public offering, there would not be a filing requirement for the

marketing of such interests. See also **2.3 Regulatory Regime** for filing requirements for the formation of J-REITs and TMKs.

4.6 Disclosure Requirements

Any person (eg, a general partner which has filed an Article 63 Notice or a placement agent) soliciting investors that are not “professional investors” (*tokutei toshika*) under the FIEA with respect to a prospective investment in an alternative fund must deliver to such non-professional investors:

- a document that includes certain matters required under the FIEA, including an explanation of the fund structure, an outline of the terms of the fund, and disclosure of certain risks and fees that may be payable in connection with an investment in such alternative fund, prior to the investor signing a subscription agreement or similar agreement, and
- a document summarising the subscription by the investor if the investor is not a professional investor.

Also, any person soliciting investors who are not “professional investors” (*tokutei toshika*) under the FIEA (or certain other investors), with respect to an investment in an alternative fund, must provide explanation of certain important matters relating to such prospective investment under the Act on Sales of Financial Products.

See also **2.18 Disclosure/Reporting Requirements**.

4.7 Tax Regime

There are no special or preferential tax regimes in Japan that might be available to investors in alternative funds, and thus tax treatment of such investors is determined under general Japanese tax laws and principles. See also **2.11 Tax Regime** for the tax treatment of Offshore Investors.

Taxation of Corporate Investors in Japan

Corporate investors resident in Japan are generally subject to Japanese taxation on their worldwide income. One exception is that a certain portion of dividends received from the fund may, depending on the circumstances and whether such dividends are deductible at the level of the distributing entity, be excluded from the amount of such investor’s taxable corporate income. Income of a corporate investor is taxed at the effective tax rate of approximately 30%, without regard to type of income.

Taxation of Individual Investors in Japan

While the income of individual investors resident in Japan is in general taxed under progressive tax rates (up to a maximum rate of 55.945%), capital gains from alienation of securities are taxed at a flat rate of 20.315%. Individual investors that receive dividends from a fund vehicle, the equity interest of which is

listed on an exchange, may, depending on the circumstances, be able to opt to be taxed at a flat rate of 20.315%.

Timing of Taxation

Where the alternative fund is opaque for Japanese tax purposes (eg, a TMK or an investment corporation established in Japan), Japanese investors are subject to tax upon receipt of profit distributions from the fund or alienation of their interest in the fund.

Conversely, where the alternative fund is transparent for Japanese tax purposes (eg, an NK or a partnership-type entity established in Japan), Japanese investors are subject to tax on their allocated share of the income derived by the fund each fiscal year, regardless of whether such income has been distributed. Since the fund is transparent, the character of such income at the fund level would generally be respected in determining tax treatment at the investor level. But see **3.5 Taxation of Carried Interest**.

In the case of a GK-TK structure, while the GK itself is opaque for Japanese tax purposes, TK investors would be subject to tax for profits allocated to them each year, whether distributed or not; however, unlike an NK or a partnership-type fund, income from such allocated profits would generally be treated as “miscellaneous income”, regardless of the character of the income at the GK level.

4.8 FATCA/CRS Compliance Regime

FATCA

Japanese alternative funds are “financial institutions” under the US Foreign Account Tax Compliance Act (FATCA). Japan and the United States have entered into a Model 2 intergovernmental agreement (IGA) with respect to FATCA. Under the IGA, Japanese alternative funds are required to comply with certain due diligence, reporting and withholding obligations. Information with respect to US investors and non-compliant investors must be reported to the US Internal Revenue Service on an annual basis, and payments of interest and dividends from certain US sources must be withheld at a rate of 30%.

The CRS

The Japanese government has also amended domestic law to implement the Common Reporting Standard (CRS) published by the Organisation for Economic Co-operation and Development. Under the amended law:

- general partners of NKs and IBLPs (in the case of alternative funds);
- GKs of GK-TK structures;
- TMKs; and
- investment corporations of J-REITs,

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Nagashima Ohno & Tsunematsu and Simpson Thacher & Bartlett LLP*

are each subject to certain compliance obligations, including identification and reporting of the tax residence and beneficial owners of their clients (ie, their investors) to the Japanese tax authorities, which will then exchange this information with tax authorities in other relevant jurisdictions under the automatic exchange of information (AEOI) framework.

JAPAN LAW AND PRACTICE

*Contributed by: Keiko Shimizu, Koichiro Yoshimura and David Azcue
Nagashima Ohno & Tsunematsu and Simpson Thacher & Bartlett LLP*

Nagashima Ohno & Tsunematsu is the first integrated full-service law firm in Japan and one of the foremost providers of international and commercial legal services based in Tokyo. While representing leading domestic and international clients, it has successfully structured and negotiated many of the largest and most significant corporate, finance and real estate transactions related to Japan. In addition to its capabilities in key commercial areas, the firm is known for pioneering domestic and cross-border risk management/corporate governance cases and large-scale corporate reorganisations. The approximately 500 lawyers at the firm work together in customised teams to provide clients with the expertise and experience specifically required for each matter. The lawyers advise both domestic and international clients on the structuring, formation and offering of alternative funds from legal, regulatory and tax perspectives, and also provide regulatory and ongoing compliance advice to investment managers.

Simpson Thacher & Bartlett LLP is a global law firm with more than 1,000 lawyers working across 32 major practice areas and almost every industry sector. Its multidisciplinary private funds practice has advised clients for over 40 years, playing a prominent role in the development of the private funds industry. Working closely with the firm's other practice areas, the private funds team advises many of the world's best-known institutional alternative asset managers, as well as smaller funds and independent boutiques. In addition to comprehensive fund formation advice, the firm provides sponsor and adviser clients with practical solutions to complex regulatory, compliance and enforcement issues, and advises sponsors of private funds worldwide. Simpson Thacher also has substantial experience in M&A transactions involving private investment firms, IPOs of alternative asset managers, credit facilities for funds and managers, and secondary transfers of private fund investments. In Tokyo for over three decades, the firm advises both Japanese and international clients on capital markets, M&A and cross-border private fund formation transactions.

Authors



Keiko Shimizu is a partner at Nagashima Ohno & Tsunematsu. One of the focuses of her practice is securities and financial services regulations, and she advises asset management companies, securities brokers, banks and other financial institutions on corporate governance,

regulatory and compliance matters. She also advises clients on the formation, marketing and operation of various collective investment vehicles such as investment trusts, hedge funds, private equity funds and fund of funds.



Koichiro Yoshimura is a tax partner at Nagashima Ohno & Tsunematsu. Koichiro has broad experience in the field of taxation, and regularly advises on tax issues affecting investment funds, their investors and managers. Between 2015 and 2017, he worked as an adviser at the

secretariat for the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (OECD). Koichiro is a member of the International Fiscal Association (IFA) and serves as the Young IFA Network representative of the Japanese branch. Koichiro is the author of *Clarifying the Meaning of "Beneficial Owner" in Tax Treaties*, 72 *Tax Notes Int'l* 761 (2013).



David Azcue is counsel in Simpson Thacher & Bartlett LLP's Asia private funds practice and co-heads the firm's private funds practice in Japan. His practice focuses on fundraisings for Asia-focused private investment funds, particularly in Japan, as well as representation of Japanese

investors and asset managers investing internationally. He advises on a broad range of strategies, including real estate, special situations, growth, developmental finance, and impact investing, with a particular focus on buyout funds. He also advises anchor investors on bespoke strategies and fund-of-one arrangements. Outside of fund formation, he advises sponsors on co-investments, structuring and implementation of credit facilities, as well as other strategic matters.

Nagashima Ohno & Tsunematsu

JP Tower, 2-7-2 Marunouchi
Chiyoda-ku
Tokyo 100-7036

Tel: +81 3 6889 7000
Fax: +81 3 6889 8000
Web: www.noandt.com

Simpson Thacher & Bartlett LLP

Ark Hills Sengokuyama Mori Tower 41st Floor
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032

Tel: +81 3 5562 6200
Fax: +81 3 5562 6202
Email: DAzcue@stblaw.com
Web: www.stblaw.com

NAGASHIMA OHNO
& TSUNEMATSU
Simpson
Thacher