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Part 4 What is Asset Management?

- The world of Asset Management and Investment

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Series Overview – 5 in total

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- Part 2: What is Corporate Finance?
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* This series is a digest of my book “[Finance Law - Fundamentals of Finance Law and Essentials of Advanced Financial Transactions](#)” (Shoji-Homu, 2016). In the text, “the Book” refers to this book.

1. Investment Funds and Asset Management Business

1-1. What is an investment fund?

An **investment fund** refers to a fund or its fund manager that collects funds from investors, invests the collected funds in companies and other entities, and returns the dividends received from the investees and profits from the sale of the investment targets to investors. More specifically, investment funds specialize in investments in various investment targets involving various risks, such as financial products including corporate stocks and real estate.

1-2. Investment Funds and Fund Managers

Investment funds are often **managed funds** in which the fund manager makes investment decisions (see: “[Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing](#)”). In an investment fund, the fund manager and the investment fund provide investors with various **financial intermediary functions** (intermediary functions for intermediating the transfer of funds between the final fundraiser and the final fund provider) as an inseparable part.

In other words, nowadays where **unbundling** (see: “[Part 1 What is Finance Law? - Collaboration between Finance and Law](#)”) has progressed, the various financial intermediary functions traditionally provided collectively by financial institutions have been broken down, and (i) **fund managers** transfer (via **SPVs**) the **function of bearing credit risk** for the investee (the function of bearing the credit risk of the final fundraiser themselves) to **investors**, while they themselves only provides the **information production function** related to asset management (i.e., the function of providing analysis, judgment, and monitoring related to the credit risk and business conditions of the fund provider) (fee business).

On the other hand, (ii) **investment funds** provide, among other financial intermediary functions, the **function of providing funds** to investees and the **function of converting assets** between investees and investors (the function of converting an asset into another in legal form while maintaining its economic value). In investment funds, fund managers and investment funds work together to provide these financial intermediary functions to investors.



1-3. Investment Funds and Asset Management Business

Asset management refers to the business of managing and operating various types of assets using information production functions to increase asset value and maximize profits. A fee business that manages assets on behalf of investors and asset owners is called an **asset management business** (or investment management business). The asset management business is a fee business that has developed largely due to the unbundling of the risk-bearing function and the information production function.

2. Types and Classification of Investment Funds

While there are various types of investment funds and classification methods, the following is a list of representative investment funds based on investment targets and objectives.

2-1. Classification by Economic Function (investment objective)

(1) Hedge Funds

Hedge funds are funds that (i) invest under a discretionary investment policy, including the use of (financial) leverage, by structuring in a format with few restrictive factors such as private placement, (ii) pursue absolute returns by investing in highly liquid assets utilizing financial engineering investment strategies, and (iii) in return for these investments, fund managers collect a contingency fee.

(2) Private Equity Funds

Private equity funds (PE funds) are funds that specialize in investments in unlisted stocks (private equity). They include (i) **Venture Capital funds** (PE funds that invest in unlisted venture companies in the startup or early stages), (ii) **Buyout funds** (PE funds that invest in companies in the growth stage or later), and (iii) **Turnaround funds** (PE funds that invest in companies in financial difficulties).



(3) Activist Funds

Activist funds are so-called “activist shareholders” that mainly acquire a few to several dozen percent of the shares of listed companies and leverage their influence as major shareholders to make shareholder proposals such as increasing dividends and replacing executives.

(4) Distressed Debt Investment Funds

Distressed debt investment funds are funds that invest in non-performing loans with default risk. Also known as **distressed funds**.

(5) Real Estate Funds

Real estate funds are funds that acquire and develop real estate and earns profits from rent and gains on sales of real estate. Real estate funds include (i) **listed REITs**, which are **publicly offered funds** (funds that receive investment from an unspecified number of investors) (see: “[Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing](#)”) and (ii) **TMK** which are **private placement funds** (funds that receive investment only from a small number of investors) (See: “[Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing](#)”) and the so-called **GK-TK scheme** (real estate investment scheme which combines a limited liability company (GK) and silent partnership (TK) investment).

2-2. Classification by Legal Form

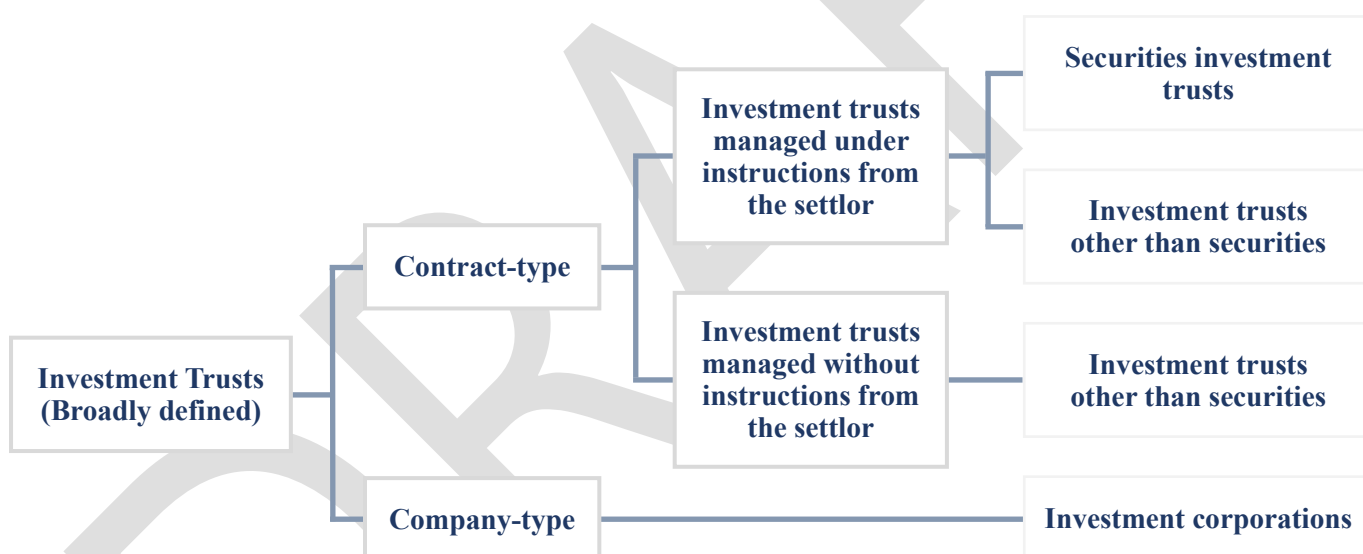
The legal forms of domestic investment funds include **company-type**, **trust-type**, and **partnership-type** (see: “[Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing](#)”), but here the funds under the Investment Trust Act (**broadly defined investment trusts**) which are frequently used in practice will be explained. Investment trusts in the broad sense are divided into (i) **trust-type (contract-type) investment trusts (investment trusts in the narrow sense)** and (ii) **company-type investment corporations**. Investment trusts are also divided into (a) **investment trusts managed under instructions from the settlor** (investment trusts that manage trust assets based on the instructions of the trustee, the investment trust management company) and (b) **investment trusts managed without instructions from the settlor** (investment trusts that manage trust assets by the trustee without instructions from the trustee), depending on who manages the fund.



Investment trusts managed under instructions from the settlor are divided into **securities investment trusts** (investment trusts which invest mainly in securities, real estate and other assets specified by Cabinet Orders (specified assets)) and **investment trusts other than securities investment trusts** (investment trusts which invest in specified assets excluding securities), depending on the investment targets. Investment trusts managed without instructions from the settlor are investment trusts other than securities investment trusts. Investment corporations are divided into **securities investment corporations** and **real estate investment corporations (REITs)**, depending on the investment targets.

【Figure 4-1】 illustrates the above.

【Figure 4-1: Types of investment trusts】



(Source: Created by the author based on a figure in “*The Fundamentals of Trusts, Fourth Edition*” (Economic Legal Research Institute, 2012), edited by Economic Legal Research Institute.)

3. Investment Fund Practice



3-1. Foreign investment funds

Foreign investment funds established and managed in foreign countries in accordance with foreign laws can also be divided into company-type, trust-type, and contract-type. A typical example of a foreign investment fund is a **unit trust**, which is a trust-type fund. Partnerships in foreign countries are generally called **partnerships**.

3-2. Fund of Funds

Fund of funds (FOF) is a fund that does not invest directly in stocks, bonds, etc., but invests in other funds that invest in those assets. By investing in multiple funds that invest in different assets, FOFs achieve diversification.

3-3. Open-Ended and Closed-End

Open-ended (type funds) are those that allow investors to freely cancel or withdraw their fund interests. **Closed-end (type funds)** are those that do not allow investors to freely cancel or withdraw their fund interests.

3-4. Investment Fund Management Policy

Investment fund management policies include **passive management** which aims for a return rate equal to the expected return rate of the market portfolio (benchmark), and **active management** which aims for an expected return rate greater than the benchmark. The balance between **return (expected rate of return)** and **risk (variance or standard deviation)** is considered in evaluating the performance of the investment portfolio. Indicators such as **Beta (β)** in **CAPM** exist as indicate the securities risk.

4. Investment Funds and Financial Regulations

In the asset management business, investors assume **the credit** and **market risk** of their investments and are often subject to **financial regulations**.

4-1. Financial Regulation of Fund Managers

Fund managers and **asset managers** are often **financial institutions** subject to financial regulations. Such financial institutions include **investment management firms** and **investment advisory firms** under the Financial Instruments and Exchange Act (FIEA), **trust companies** under the Trust Business Act, **trust**



banks under the Act on Engagement in Trust Business Activities by Financial Institutions, and **insurance companies** under the Insurance Business Act (details will be explained in Part 5 of this series).

In addition to the above business regulations, fund managers and asset managers are also subject to various conduct regulations, such as **insider trading regulations** and **conflict of interest regulations** (details will be explained in Part 5 of this series).

4-2. Financial Regulation of Funds

(1) Fund regulations under special laws

Special laws concerning funds, including systems for investor protection (financial regulations), include (i) special laws concerning **company-type** or **trust-type funds** and (ii) special laws concerning **partnership-type funds**. The former ((i)) include the Act on Securitization of Assets (**SPC Act**) applicable to **liquidation-type funds** and the Act on Investment Trusts and Investment Corporations (**Investment Trust Act**) applicable to **management-type funds** (See: “[Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing](#)”). For example, notification is required for investment trusts and TMKs, and notification and registration are required for REITs. In the case of **foreign investment funds**, notification is required if these are similar to investment trusts or investment corporations. The latter ((ii)) include the Limited Partnership Act for Investment (**LPS Act**), the Limited Liability Partnership Act (**LLP Act**) and the Act on Specified Joint Real Estate Ventures (**ASJRE**).

(2) Fund regulations under the FIEA

Equity investments by **Collective Investment Schemes** (See: “[Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing](#)”) involve various risks, such as the risk of investment solicitation without sufficient information, the risk of suffering losses due to damage or price decline of the investment target, and the risk of suffering losses due to lack of management ability of the fund manager. Therefore, in order to protect equity investors in collective investment schemes, various laws and regulations regulate (i) the solicitation of investments by funds itself and (ii) the management of funds collected from investors. Typical examples of such regulations are (i) **self-solicitation regulations** and (ii) **self-management regulations** under the FIEA.



(i) **Self-solicitation regulations**

When a fund SPV solicits fund investors to invest (interest) in a fund (equity), it falls under the category of a **self-solicitation business** under the FIEA, and in principle this requires registration as a **Type II Financial Instruments Business** (details will be explained in Part 5 of this series).

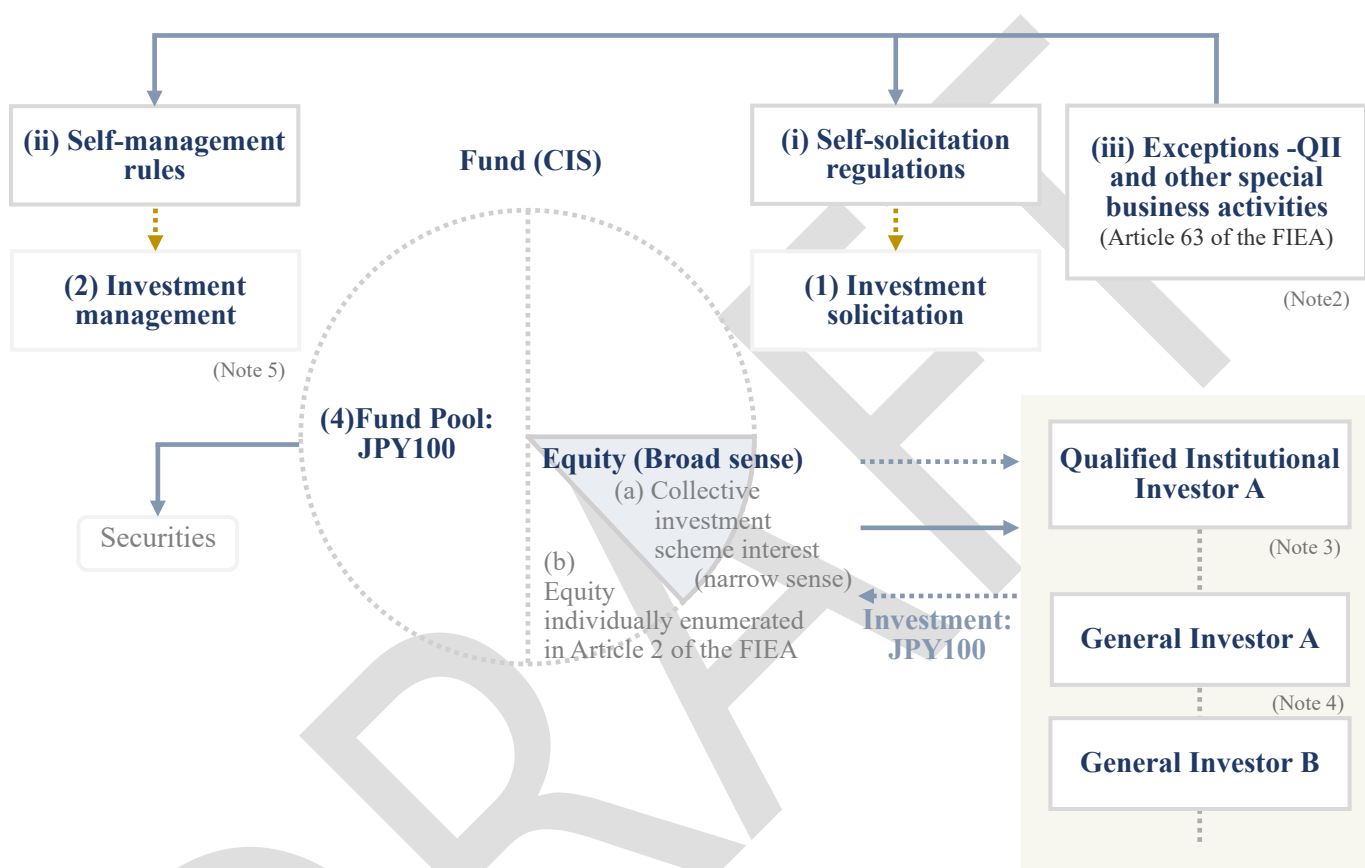
(ii) **Self-management regulations**

If a fund uses (manages) investments (equity) from fund investors and invests mainly in securities or derivatives transactions, it falls under the category of **self-management business** under the FIEA and, in principle, requires registration as an **investment management business** (details will be explained in Part 5 of this series).

In practice, self-solicitation and self-management are often conducted without registration of the above, utilizing the various exemptions allowed under the FIEA. A typical example of such exemptions is the **Special Business Activities for Qualified Institutional Investors (QII Exemption)**, in which a fund invested by one or more Qualified Institutional Investors and a small number of investors other than Qualified Institutional Investors (49 or fewer) (referred to as **General Investors** in the Book) may self-solicit or self-manage with just notification. The above is summarized in [Figure 4-2].



【Figure 4-2: Regulations on collective investment schemes and special exceptions such as SPBQII】



Note 1) This figure has been created based on the same one as 【Figure 3-2】 (“**Part 3 What is Structured Finance / Asset Finance? - Fund / SPV-based financing**”).

Note 2) Notification to the Financial Services Agency is required

Note 3) At least one Qualified Institutional Investor is required

Note 4) Less than 49 investors other than Qualified Institutional Investors are required

Note 5) Investing “primarily” (i.e., more than 50%) in securities

The same Collective Investment Scheme regulations as above are basically imposed on foreign Collective Investment Schemes.



This concludes the explanation on asset management. In the next part, **Financial Regulation Law** will be explained.

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