THE VENTURE CAPITAL LAW REVIEW

SECOND EDITION

Editor
Hajime Tanahashi

THE LAWREVIEWS

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Hajime Tanahashi, Mikito Ishida and Takahiro Iijima[1]

I OVERVIEW

i Market trends

Prior to the covid-19 pandemic, venture capital (VC) investments had been very active in Japan for several years. According to a report published by Venture Enterprise Center, Japan,[2] investments by VC funds in Japan increased continuously every year from 2014 to 2020. Although the pandemic led to a temporary downturn in the start-up investment market, which resulted in fewer investments in 2020 (1,160 deals of around ¥150 billion in aggregate), there was recovery in 2021 resulting in 1,395 deals totalling around ¥228 billion in aggregate investments. This trend looks to continue in 2022, as investments by VC funds in Japan totalled ¥80 billion (nearly 450 deals) in the first quarter of 2022 alone, which was the highest recorded total for a quarter since 2014.

Fund formation has remained consistently active. Although the total amount raised by newly formed VC funds dropped from around ¥344 billion in 2020 to around ¥292 billion in 2021, the number of funds has not changed (54), which suggests that investors are still active despite the relatively low new fundraising in the first quarter of 2022 (around ¥28 billion, 10 funds) foreshadowing the latest worldwide downward trends.

Overall, the demand for investment by start-ups still looks fairly positive, although we should closely monitor investor sentiment in light of the recent domestic and global slump in the initial public offering (IPO) market.

ii Types of funds

While a majority of VC funds invest in various sectors and have no specific areas of investment focus, there is a moderate number that expressly focuses on specific industries. For example, there are many area-focused funds such as in the IT/TMT, 'Web 3', life sciences, property technology, drone technology and space industries. Another recent trend in the ecosystem is impact funds that seek to invest in start-ups that will contribute to society as a whole.

Corporate venture capital (CVC) is also growing rapidly. While the objectives vary, CVC funds tend to focus more on strategic alliances with start-ups, which lead to potential mergers and acquisitions, than on maximising financial returns.

There are also VC funds organised under the programmes and mostly by the funds of the Japanese government called public–private investment funds. These funds aim to

1 Hajime Tanahashi and Mikito Ishida are partners and Takahiro Iijima is a senior associate at Mori Hamada & Matsumoto.

2 Venture Enterprise Center website (www.vec2.jp).

invest in areas such as emerging technologies that may contribute to the Japanese economy from a long-term perspective but have a risk-return profile that is not attractive for private sector funds.

iii LP investors

Most VC funds obtain funding through private placements. Currently, the most active investors in VC funds are financial institutions (i.e., banks, insurance companies and securities firms) and corporate investors. Various Japanese corporations are seeking collaborations with start-ups (open innovation) and becoming more interested in investing in VC funds as a source of information on new technologies, in addition to making direct investments in start-ups. Another major investor is the Organization for Small & Medium Enterprises and Regional Innovation (SMRJ), which is an independent administrative agency tied to the Japanese government. In a typical scheme, the SMRJ can invest up to 50 per cent of the entire commitment of a VC, with a cap of ¥8 billion.

While Japanese pension funds were historically not as interested in allocating their assets to VC funds, they have started to show interest and are gradually increasing investment allocation in VC funds.

iv Ecosystems and locations

Geographically, many start-ups, funds and other supporters, such as business incubators, professionals and co-working spaces, are still based in Tokyo, but there is a trend towards establishing start-ups in other locations to foster development in regional economies. In 2020, the Japanese government designated four consortiums composed of local governments, academia and private players located in major areas (i.e., Greater Tokyo, Nagoya, the Osaka and Kyoto region, and Fukuoka) and several other cities as 'start-up ecosystem hubs' that the government will intensely support. This general trend is backed partly by the remote work environments currently being used due to the covid-19 pandemic.

II YEAR IN REVIEW

i Funds

The Japanese government is currently committed to expanding Japan's role as an international finance hub and is keen to solicit overseas fund managers to set up their offices in Japan. In line with this policy, over the past year the government has enacted several regulatory changes that generally mitigate restrictions imposed on investment funds.

In June 2021, the Act on Strengthening Industrial Competitiveness was amended to introduce a minister's approval that lifts certain restrictions on overseas investment by Japanese funds (see Section III).

In November 2021, the amended Financial Instruments and Exchange Act of Japan (FIEA) came into effect and introduced a new exemption for funds that mainly have overseas investors (the Overseas Investors Exemption; see Section III).

As for partnership taxation, the National Tax Agency issued guidance in April 2021 clarifying that carried interests should be treated as capital gains, which enjoy preferable tax attribution, rather than as labour income, as long as individual fund managers receive it as a distribution pursuant to a partnership agreement and the carried interest is economically reasonable based on the managers' financial and labour contributions and other factors.

ii Investment and start-up ecosystem

The Japanese government is trying to enhance innovative ecosystems, including those in the venture capital and start-up market. One of these efforts is the designation of the aforementioned start-up ecosystem hubs. Another example is a report published by the Ministry of Economy, Trade and Industry (METI) in late 2020 for the start-up industry on how to make use of 'convertible securities' (i.e., convertible equity and bonds or notes; see Section VI) in the seed or early stages and how start-ups should collaborate with corporate investors.

The government is also trying to tackle issues raised by the expansion of the start-up ecosystem. For instance, as players in start-up investment become diverse, and Japanese corporations and CVC funds expand their presence in investing in and collaborating with start-ups (open innovation), a growing number of negative reactions are being reported on the inequity of bargaining power between the investors and start-ups. Several reports and guidelines have been released and revised from 2020 to early 2022, including a report by the competition law authority, the Japan Fair Trade Commission (JFTC), on competition law issues that may arise from collaborations among large companies and start-ups. The JFTC and METI then issued guidelines on best practices for this type of collaboration and investment from large companies to start-ups, and the Japan Patent Office published model agreements and commentaries on certain types of collaborative contracts, such as joint research and development agreements and licence agreements, both of which were updated in early 2022.

Based on the reports by a working group of the Financial Services Agency (FSA), the Japanese financial regulatory authority and the Japan Securities Dealers Association (JSDA), a self-regulated organisation of securities brokers and dealers, each issued in June 2021 several reforms that have been made or will be introduced in 2022 to expand the pathways and players that provide funds to start-ups. These include:

a expansion of the secondary market of unlisted companies by widely permitting securities brokers and dealers to solicit unlisted stocks to a broader range of professional investors with the introduction of proper solicitation rules by the JSDA;

b a more flexible transition from non-professional to professional investors; and

c relaxation of the restrictions on the Crowdfunding Exemption (see Section VI).

III LEGAL FRAMEWORK FOR FUND FORMATION

i Legal entities

There are several vehicles available under Japanese law for VC funds. In the very early years, a partnership under the Civil Code, which is similar to a general partnership in other jurisdictions, was used for most of the VC funds. While a general partnership is a tax pass-through entity, all partners are subject to unlimited liability. Therefore, the investment limited partnership (ILP) has become the most frequently used fund vehicle in Japan since it became available under a special law (the Act on Investment Limited Partnership Agreement) enacted in 1998 originally for the purpose of fostering sound growth and development of small and medium-sized businesses in Japan by the funds from limited partnerships. An ILP is similar to a limited partnership in other jurisdictions and must be formed by at least one general partner and one limited partner. While limited partners in an ILP have limited liability that does not exceed the extent of their capital contributions to the fund, the general partners bear unlimited liability to third parties in respect of the liabilities incurred by the fund.

An ILP has some disadvantages for fundraising from global investors or investing in foreign start-ups. For instance, an ILP is prohibited from investing 50 per cent or more of its contributed capital in foreign corporations. However, it should be noted that the June 2021 amendment of the Act on Strengthening Industrial Competitiveness introduced a new exemption where this restriction on overseas investment may be lifted for ILPs whose plans for enhancing open innovation by their investments are approved by the minister of METI.

In addition, while an ILP is a pass-through entity for Japanese tax purposes for Japanese investors investing in Japanese start-ups, overseas investors who invest in those start-ups through an ILP are generally treated as conducting a business activity and thus as having a permanent establishment (PE) in Japan, which will result in Japanese taxation on the income attributable to the PE. There is an exemption where the income of the foreign limited partners of an ILP is non-taxable if they satisfy certain requirements (e.g., not engaging in fund management, holding less than 25 per cent of the ILP interests, having no special relationship with the general partner, and having no other PEs in Japan).

To overcome these restrictions, VC funds that seek fundraising from global investors or intend to invest in foreign start-ups frequently use overseas limited partnerships (e.g., Cayman Islands or Delaware limited partnerships).[3]

A limited liability company, which is not a pass-through entity, is sometimes used as an investment vehicle for CVC funds.

The general partner of an ILP is often organised as a joint-stock company, which is the most typical type of corporation in Japan, or as a limited liability company, in order to benefit from the limited liability attributes of those types of vehicles. In addition, an increasing number of VC funds are now using a limited liability partnership as the general partner vehicle. While all partners of a limited liability partnership must be engaged in its management, it is treated as a pass-through entity for tax purposes. The general partners of some small VC funds are individuals, which is also allowed.

ii Financial regulations and structures

Regulations on general partners – registrations and the Article 63 Exemption

VC funds are typically formed as partnerships (including ILPs and offshore partnerships), the interests in which are recognised as a 'collective investment scheme' and treated as 'deemed securities' under the FIEA. Therefore, a VC fund that has Japanese investors, regardless of

3 It should be noted that, under Japanese tax law, if a foreign investor without a PE in Japan owns 25 per cent or more shares in a Japanese company at any time during the last three years, the capital gains on the transfer of 5 per cent or more of those shares will be taxed (as a 'business transfer') unless exempted under any applicable tax treaty. Before 2009, in the case of investment by a (domestic or overseas) partnership, the 25 per cent threshold was judged at a fund level and triggered if the partnership invested in 25 per cent or more shares in a Japanese company regardless of the limited partner's interest ratio. The threshold is now calculated based on each limited partner, and each foreign limited partner will not be taxed if it (together with certain special related parties) does not hold 25 per cent or more shares in a Japanese company via its partnership interest and meets certain criteria similar to the PE exemption referred to herein.

where the general partner is located or where the fund is formed, is subject to regulations under the FIEA. That is, the general partner is in principle required to register with the FSA (the relevant Japanese regulatory authority) in respect of its:

a offering activities in Japan or to investors residing here (which requires registration as a 'Type II Financial Instruments Business Operator'); and

b investment management activities (which requires registration as an 'Investment Management Business Operator').

This registration is a document-intensive and time-consuming process that generally requires several months' preparation. Therefore, almost all VC fund operators (general partners) typically use an exemption under the FIEA called the 'Exemption for Special Business Activities for Qualified Institutional Investors (QIIs)' stipulated in Article 63 of the FIEA (Article 63 Exemption) for either the offering or investment management, or both.

To qualify for the Article 63 Exemption, the general partner must file a short document called a 'Form 20' with the FSA together with ancillary documents that may be prepared in English. The entire list of Article 63-exempted operators is publicly available on the FSA's website.[4]

The Article 63 Exemption has several requirements such as:

a having at least one investor that is a QII;

b having no more than 49 Japanese investors that are eligible as non-QII fund investors (those with 'investment judgement capability' or 'closely related to the fund manager') (e.g., corporations or individuals that own ¥100 million or more in securities (individuals must also have a securities account for at least one year)); and

c the partnership interests must be subject to certain transfer restrictions.

The Article 63 Exemption includes a fund-of-funds regulation that incorporates a look-through rule, and investors in feeder funds must also be counted against the 49 non-QII investor threshold. Moreover, certain types of feeder fund vehicles are subject to stricter restrictions.

It should be noted that even if the Article 63 Exemption applies, the general partner is still required to comply with certain ongoing obligations such as submitting an annual business report together with financial statements to the FSA, and it is subject to supervision and enforcement by the FSA (see Section V).

QIIs

A cabinet order under the FIEA prescribes the various types of QIIs. For example, Japanese banks and insurance companies are enumerated as QIIs. Companies and individuals that hold at least ¥1 billion in investment assets (securities) may become QIIs by filing with the FSA and renewing such filing biennially. The list of QIIs is available on the FSA's website.[5] They are considered 'professional investors' under the FIEA, and therefore some of the regulations are loosened for financial transactions made with them.

4 https://www.fsa.go.jp/menkyo/menkyoj/tokurei.html.

5 https://www.fsa.go.jp/common/law/tekikaku/index.html (only available in Japanese).

Venture capital funds exemption – wider eligibility for non-QIIs

While a major reform of fund regulations under the FIEA in 2016 led to stricter compliance regulations for the Article 63 Exemption (see Section V), it also introduced an exemption that allows wider eligibility for non-QII investors than the ordinary Article 63 Exemption if the general partner and the fund satisfy certain additional requirements (VC Funds Exemption). The major additional VC Funds Exemption requirements are:

a more than 80 per cent of the capital contributions (other than cash and equivalents) are invested in non-listed stocks and share acquisition rights;
b loans and guarantees by the fund are limited to a certain ratio and term;
c certain basic provisions including the ones for protecting the interests of limited partners are stipulated in the partnership agreement; and
d the partnership agreement must be submitted to the FSA.

If the general partner and the fund satisfy the VC Funds Exemption requirements, the general partner may solicit a broader scope of non-QII investors than under the ordinary Article 63 Exemption. The investors additionally eligible under the VC Funds Exemption have a variety of characteristics, but mainly include angel investors, start-up (ex-)founders and management, and certain other professionals.

Overseas fund or investor exemptions

If all or most of the VC investors are foreign residents, other exemptions may be relied upon. One exemption is the *de minimis* Japanese QII exemption, which may be used by overseas funds that meet certain requirements (e.g., the overseas fund has fewer than 10 Japanese QII investors that directly or indirectly contribute no greater than one-third of the fund's total contributions). This exemption applies only to investment management regulations, and not to offering regulations. Therefore, the overseas general partner must retain a registered placement agent (Type II Financial Instruments Business Operator) without conducting the offering on its own or must rely on the Article 63 Exemption for offerings.

An additional exemption for general partners in Japan came into effect in 2021 by the amended FIEA (the Overseas Investors Exemption). This exemption may be used by general partners that have a business or representative office in Japan and meet certain requirements (e.g., all investors are foreign-resident professional investors, QIIs, or their closely related parties, and foreign investors contribute more than half of the fund's total contributions). It is applicable to both investment management and offering regulations and is subject to regulations similar to the Article 63 Exemption, such as prior notification to and supervision and enforcement by the FSA, a fund-of-funds regulation, and ongoing obligations. A major difference is that the Overseas Investors Exemption does not require any QII investors and there is no limit on the number of investors, while the Article 63 Exemption has such requirements.

Other offering-related regulations (marketing and solicitation)

Regardless of whether a general partner is registered or an Article 63-exempted operator, the marketing and advertising of a VC fund is subject to the advertising regulations under the FIEA. Advertising made by a general partner of the fund should comply with certain requirements, such as explaining material risks and relevant fees of the fund to non-professional investors.

Based on the disclosure rules under the FIEA, unless there are 500 or more limited partners in the fund, the offering will be categorised as a private placement for which no official prospectus is required. However, in practice, some VC funds distribute informative documents for the convenience of potential investors.

IV FUND AGREEMENTS

Typical VC funds in Japan have a life of 10 years, with the right to extend for another year or two by the general partner. Within those 10 years, a typical VC fund makes new investments in the first five years and disposes its portfolio companies during the latter five years.

When establishing Japanese ILPs, many VC funds use the model partnership agreement provided by METI in 2010 (the 2010 Model Agreement) or the one provided in 2018 (the 2018 Model Agreement) as the basis of their own agreements.[6] While the 2010 Model Agreement can also be the basis of private equity or buyout funds, the 2018 Model Agreement focuses on VC funds with provisions to satisfy the VC Funds Exemption. Some of the major protections granted to the investors in the model agreements that are similar to those for overseas funds are:

a limited partner consent to conflict-of-interest transactions;
b establishment of an advisory board and the right to nominate advisory board members;
c suspension of the investment period if a key person event occurs;
d general partner clawback;
e a management fee deduction of certain fees that the general partner receives from portfolio companies;
f removal of a general partner for any material breach; and
g dissolution of the fund upon unanimous consent of the limited partners.

The typical distribution rules for profits between fund managers (general partners) and investors (limited partners) in Japanese ILPs are similar to those for overseas funds. General partners typically receive 20 per cent of distributable profits, subject to a waterfall structure including a hurdle rate, catchup and general partner clawback. The level of carried interest rate and whether such waterfall items are stipulated depend on the negotiations between the general partner and limited partners, but a number of VC fund agreements do not contain a hurdle rate or catchup.[7] When some investors request a hurdle rate against VC funds, 8 per cent is typical, as is the case with buyout funds in Japan.

V FUND MANAGEMENT

Prior to a major reform of fund regulations under the FIEA in 2016, Article 63-exempted operators were only subject to a limited number of compliance regulations, such as a prohibition on making false statements or compensating losses incurred by investors. After the amendment of the FIEA, the regulatory obligations imposed on the Article 63-exempted operators have increased significantly. The following are some of the major regulations.

6 The 2010 Model Agreement has English translated version, while the 2018 Model Agreement does not.
7 The 2018 Model Agreement does not contain a hurdle rate or catchup.

i Stricter compliance regulations since 2016

Since 2016, Article 63-exempted operators have been subject to many compliance regulations that historically were applicable only to registered financial instruments business operators, including the following:

a delivering a notice to each professional investor stating that it has the option to change its status from a professional to a non-professional investor;
b delivering explanatory documents detailing important risks of the fund, which should be delivered twice (prior to and at the time of subscription) to non-professional investors;
c delivering an investment management report to non-professional investors periodically;
d keeping certain records of financial transactions for a maximum of 10 years;
e segregating fund assets from the operator's own assets;
f notifying the FSA of any lawsuit or violation of law;
g fulfilling certain advertising requirements, including the provision of a description of fees charged by the operator; and
h complying with the duties of good faith and fairness, loyalty and care of a good manager.

ii Public disclosure by the Article 63-exempted operator or FSA

Article 63-exempted operators must comply with certain ongoing disclosure obligations, including the following:

a without delay, after filing Form 20, making certain excerpted information (Form 20-2) publicly available, and the contents of which are also disclosed by the FSA;
b submitting a business report (Form 21-2) within three months of the end of each fiscal year; and
c making a disclosure booklet (Form 21-3) publicly available for a period of one year, commencing four months after the end of the relevant fiscal year.

iii Ancillary activities

While a registered Investment Management Business Operator is prohibited from conducting businesses other than investment management, certain enumerated businesses and ancillary ones, an Article 63-exempted operator is not subject to such restrictions.

VI RAISING CAPITAL BY START-UPS

i Forms of interest

Start-up investments normally take the form of equity investments. While major seed or early investments are made through common stock or preferred stock with a liquidation preference, a growing number of these investments are using convertible bonds or equity, which often grant economic terms to investors similar to those in other countries such as SAFE (simple agreement for future equity) or KISS (keep it simple security) in the United States. Convertible equity in Japan often takes the form of share acquisition rights (stock options). The most well-known seed-round convertible equity format in Japan is called J-KISS, which is publicised by 500 Startups Japan (now Coral Capital).

From early to later and pre-IPO stages, preferred stock has become the prevailing instrument over common stock in the past decade, although the latter is still used in a certain number of start-up investments. Standard economic terms of preferred stock are similar to those in other countries, especially the United States, such as:

a preferred dividends (non-cumulative and non-participation in many cases);
b liquidation preference, which will be triggered in liquidation and certain exit events (deemed liquidation events), typically with 1x participation rights;
c anti-dilution protection, with broad-based weighted average in most cases;
d the right to appoint directors (but sometimes stipulated only in the shareholders' agreement); and
e protective provisions for certain corporate events (but more often stipulated only in the shareholders' agreement).

ii Crowdfunding

Crowdfunding is permissible in Japan. Generally, registration as a Type I Financial Instruments Business Operator is required in order to perform brokerage, intermediary and agency services to trade stocks and share acquisition rights, irrespective of whether by means of crowdfunding through the internet or public offering through securities exchanges. Following the FIEA amendment in 2014, the regulations were relaxed so that crowdfunding operators who only engage in certain small-scale crowdfunding through the internet can easily register as 'Small-amount Electronic Public Offering Business Operators' (Crowdfunding Exemption).[8]

Although the number of businesses registered as Crowdfunding Exemption operators is not particularly large (as at April 2022 there are five operators), the number of seed to early-stage start-ups that raise their funds via equity-type (e.g., stocks and share acquisition rights) crowdfunding is gradually increasing.

Start-ups must be careful about certain limitations on equity-type crowdfunding using the Crowdfunding Exemption. For instance, the amount that one investor can invest in a start-up via the exemption has been limited to ¥500,000 in total. Further, the maximum amount of funds that each start-up can raise via the exemption is limited to ¥100 million in one year. However, it should be noted that these limitations were loosened by the recent 2022 reform in order to facilitate the use of crowdfunding (see Section II). As a result of the reform, the ¥500,000 cap now only applies to non-professional investors, and the calculation of the ¥100 million limitation now excludes other equity funding in addition to the Crowdfunding Exemption, such as that from VC funds. Still, a certain number of venture capitalists have shown concerns about the consequences of the current equity-type crowdfunding, such as (1) the existence of a large number of small investors that are not subject to a shareholders' agreement (e.g., drag-along rights); (2) statutory provisions under the Companies Act applicable to small shareholders that would hinder flexible business operations; and (3) know your customer (KYC) concerns. At the current stage, crowdfunding operators are constantly tackling these concerns and improving their services.

8 For more details of crowdfunding regulations, see the Japan chapter in *The Financial Technology Law Review* (Atsushi Okada, Takane Hori, and Takahiro Iijima) (https://thelawreviews.co.uk/title/the-financial-technology-law-review/japan).

iii Investment agreements

Forms

There are no standardised investment documents circulated in Japan. However, METI published a report in 2018 providing a standard term sheet template and commentaries. Practically, there is generally consensus within the VC industry in Japan on the type of terms and conditions that are 'standard' for start-up investments in this country.

Typically, Japanese VC investments involve two contracts: the share subscription agreement and the shareholders' agreement. Sometimes the latter will be split into two agreements: one containing most of the provisions (e.g., board election, protective provisions, right of first refusal, tag-along rights) executed by major shareholders and the other containing only deemed liquidation or drag-along rights executed by all shareholders.

The contents of the investment agreements for non-listed start-ups are not required to be disclosed to the public. However, the major terms of preferred stock stipulated in the articles of incorporation (e.g., preferred dividends, liquidation preference, anti-dilution protection) must be filed with the commercial registry and thus become publicly available.

Contractual protections and rights given to investors in Japanese start-up investments are mostly similar to those given globally, especially those stemming from US-style investments. The major terms are as follows.

Management control

Board seats are often requested by major investors (especially lead investors). Unlike the Silicon Valley model, outside directors rarely comprise a majority of the board. A wider range of investors are given observer rights, and they are also given information rights (especially the right to receive various financial information), inspection rights and protective provisions for certain corporate actions.

A non-competition clause, often included to ensure the commitment of the founders, is enforceable in Japan to a reasonable extent.

Share transfer restrictions

For most Japanese start-ups, pursuant to the Companies Act, their articles of incorporation stipulate that share transfers are subject to board approval (or approval by another corporate body as applicable). In addition, rights of first refusal and tag-along rights are granted to investors in many shareholders' agreements. While a right of first refusal will only be triggered by a share transfer by management shareholders in many cases, there are other cases where share transfers by investors also trigger the right.

In relation to facilitating an exit, we see an increase of drag-along rights included in many shareholders' agreements. These rights are normally triggered by a majority of preferred shareholders, but recently this would be subject to board approval. Some drag-along rights are only triggered at a certain threshold of the sales value, but most of them do not have such a threshold.

Pre-emption rights

Pre-emption rights (on a pro rata basis) are often granted to investors in shareholders' agreements. However, in practice, the allotment of new share issuances will be discussed with existing investors well in advance, and those who do not wish to make follow-on investments will simply waive the pre-emption rights in most cases.

Put option to management shareholders and company

One unique right historically granted to investors in Japan has been a put option to the issuer (start-up) and management shareholders (mainly founders), which will be triggered by certain events such as their material breach of investment agreements. Moreover, in some cases, a failure of an IPO after a certain number of years from the investment has been one of the put option events. Some founders argue that this obligation is too burdensome and unfair, and they sometimes succeed in being excluded from or mitigating their obligation. While this issue is still controversial and has no dominant market standards, the guidelines on best practices for collaboration among large companies and start-ups, and on investment by the former in the latter, revised by the JFTC and METI in 2022 (see Section II), suggest mitigating the conditions of such put options (e.g., limiting trigger events and excluding individual founders and management shareholders from such obligations).

iv Investment regulations

Securities regulation

Investment from VC funds typically takes the form of a new share issuance by an investee, which is regulated by Japanese securities regulations under the FIEA. Most offerings by start-ups, however, are private placements that are exempted from filing requirements under the FIEA. Apart from that, the investee is required to submit a commercial registration of any increase in its issued shares within two weeks after the date of issuance.

Restrictions on foreign direct investment

Pursuant to the Foreign Exchange and Foreign Trade Act of Japan (FEFTA), any investment by a foreign entity, including a foreign VC fund (i.e., a fund having a majority of general partners who are foreign residents, or having at least half of its total contributions made by foreign residents (under the FEFTA definition)), in a Japanese company in any of the specified restricted businesses will generally require a filing under the FEFTA before the investment is made. The list of restricted businesses was expanded in 2019 (while partly narrowed in 2020) to align with the global trend of tightening scrutiny on foreign investments in critical technologies. Many start-ups that develop software products are likely to fall under that list. If a prior filing is required, the investment cannot be made for 30 days after the filing (unless the period is extended by the government), although this period may be shortened on a case-by-case basis.

VII EXIT

i Exit strategies

Historically, the IPO has been the main exit scenario for successful start-ups backed by VC funds in Japan. If a portfolio company goes public, VC funds typically sell their shares gradually in the stock market as the statutory or contractual lock-up period lapses.

M&A transactions, mainly in the form of stock sales in start-up deals, have recently become more common in Japan as an exit measure, and they are now used at nearly the same frequency as IPO exits.[9] Strategic investors (such as listed companies), a growing number of which were former start-ups that went public, are now seen as good candidates as potential acquirers.

ii Exit mechanisms

Provisions in the articles of incorporation for mandatory conversion of preferred stock will typically be triggered when the board of directors approves an IPO application. However, the concept of a 'qualified IPO' with a certain threshold is not so common in Japan.

Many shareholders' agreements include a clause that obliges the founders to make reasonable efforts to go public within a certain period. However, the legal and practical effect of this clause is relatively limited as this is an effort obligation and investors including VC funds often have no choice but to agree to extend the period if the start-up is not able to go public within the initially stated period.

Due to the increase in M&A exits, drag-along rights are becoming more important as a measure to accomplish a 100 per cent acquisition by the acquirer.

iii Exits of non-successful companies

The secondary market for unlisted shares of the portfolio companies of VC funds is still not mature in Japan. In many cases, VC funds ask non-successful companies or their founders to buy back their shares, although VC funds cannot expect a positive return in most cases.

iv Special purpose acquisition companies

The special purpose acquisition company (SPAC) is currently not available as a means of going public on Japanese stock exchanges, and the regulators (including the Growth Strategy Council of the Cabinet Secretariat) and stock exchanges are still discussing whether to introduce the concept in Japan. Therefore, a currently available path for Japanese start-ups considering a (De-)SPAC listing is to use a SPAC in another jurisdiction such as the United States.[10]

VIII OUTLOOK

There are several trends in the VC market worth pointing out. From the perspective of investor characteristics, while investors have been segmented between start-ups and other investments, such as public trading and buyouts, the number of crossover investors is increasing, as is the number of private equity (buyout) funds that also invest in start-ups, particularly in a later stage. This has led to greater valuation and larger IPO exits for start-ups, although it is unclear whether the trend will continue amid the worldwide market downturn in 2022.

9 According to a survey by Ernst & Young, the number of M&A exits increased from 2015 (53 deals, or almost 60 per cent of the number of IPO exits (81 deals)) to 2020 (90 deals, or almost the same number of IPO exits (91 deals)) (https://www.ey.com/ja_jp/start-ups/start-up-m-and-a-trend-survey-2020). An example of a Japanese start-up choosing M&A as a more preferable exit over IPO, and the growing trend of cross-border start-up M&As, is the acquisition of Paidy, a Japanese BNPL (buy-now-pay-later) start-up, by PayPal for ¥300 billion.

10 A recent example is Coincheck, one of the largest Japanese crypto exchanges, which announced in March 2022 that it is targeting De-SPAC listing on NASDAQ in 2022.

The de facto practice of granting put options exercisable against founders (see Section VI) may be scrutinised further. Since the guidelines were published by the JFTC and METI in 2021 and further revised in 2022 (see Section VI), the market participants have been paying attention to how the practice of granting put options will change.

A working group organised by the FSA has been discussing how to expand the pathways that provide funds to unlisted start-ups. The group submitted an interim report in June 2022 that indicates possible reforms including:

a facilitating investment trusts to include unlisted start-up shares in their portfolios, by establishing a proper framework of valuation and risk management of these shares;

b facilitating transactions of unlisted start-up shares in private trading systems (PTS) by establishing a proper framework allowing PTS to deal with certain shares tradable only by professional investors; and

c creating new security interests in the entire business of start-ups to enhance their debt financing.

Appendix 1

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Hajime Tanahashi is a partner at Mori Hamada & Matsumoto and has great expertise in corporate law, M&A, private equity, venture finance and corporate governance. He has also represented various domestic and international private equity funds. He is the author of various publications concerning private equity, domestic and cross-border M&A and tender offer bids in Japan. He has been a lecturer at Waseda University School since 2005 and is a director and member of the Industrial Innovation Committee at the Innovation Network Corporation of Japan (currently INCJ Limited). He also serves as Comptroller of the University of Tokyo. He was admitted to the Bar in Japan in 1992 and in New York in 1997

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