



**Morgan Lewis**

# **CORPORATE VENTURE CAPITAL (CVC) INVESTMENT IN US STARTUPS**

## **(PART I) FUND FORMATION AND INVESTMENT STRUCTURES**

**Morgan, Lewis & Bockius LLP**

**Nancy Yamaguchi (San Francisco & Silicon Valley Offices)**

**Narumi Ito (San Francisco & Tokyo Offices)**

**Tomoko Fuminaga (Tokyo Office)**

# 1. Introduction



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# Presenters



**Nancy Yamaguchi**



**Narumi Ito**



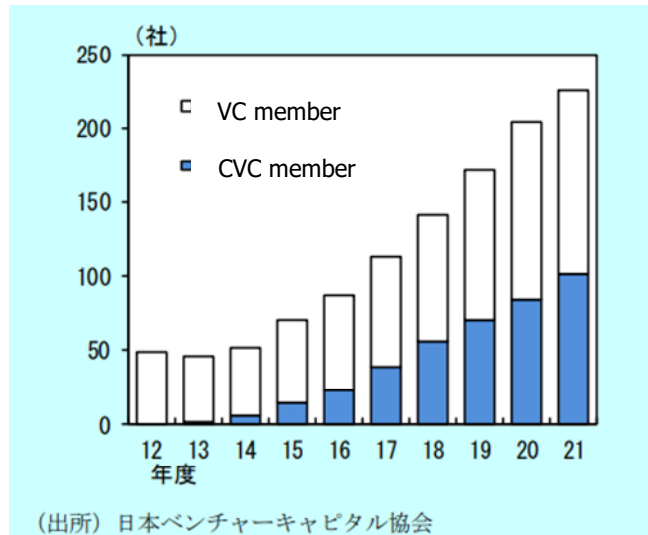
**Tomoko Fuminaga**

**Morgan Lewis**

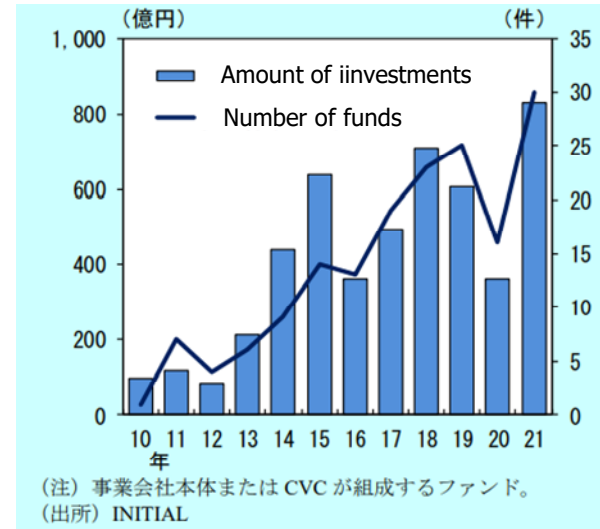
# Recent Trends in CVC in Japan (1)

- The number of CVC funds and the amount of investments, particularly CVC funds investing in areas of digital transformation (DX) and climate change, has been increased.

Number of members in Japan  
Venture Capital Association



Trends in the formation of funds  
formed by business corporations



# Recent Trends in CVC in Japan (2)

According to the "Research Study on Corporate Venturing and Development in Japan" (November 2018 survey, published in April 2021), prepared by the Japan Venture Capital Association:

- CVCs that invest large amounts in many startups achieves higher investment return. In order to increase investment returns, it is necessary to achieve good investment performance, and this requires continuing CVC activities for a long period of time
- Compared to Japanese CVCs, global CVCs are:
  - Investing large amounts in many startups
  - Realizing high performance in investment return
  - Seeking to achieve both strategic and financial returns
  - Actively investing in its own business areas, and actively involving themselves in management of startups

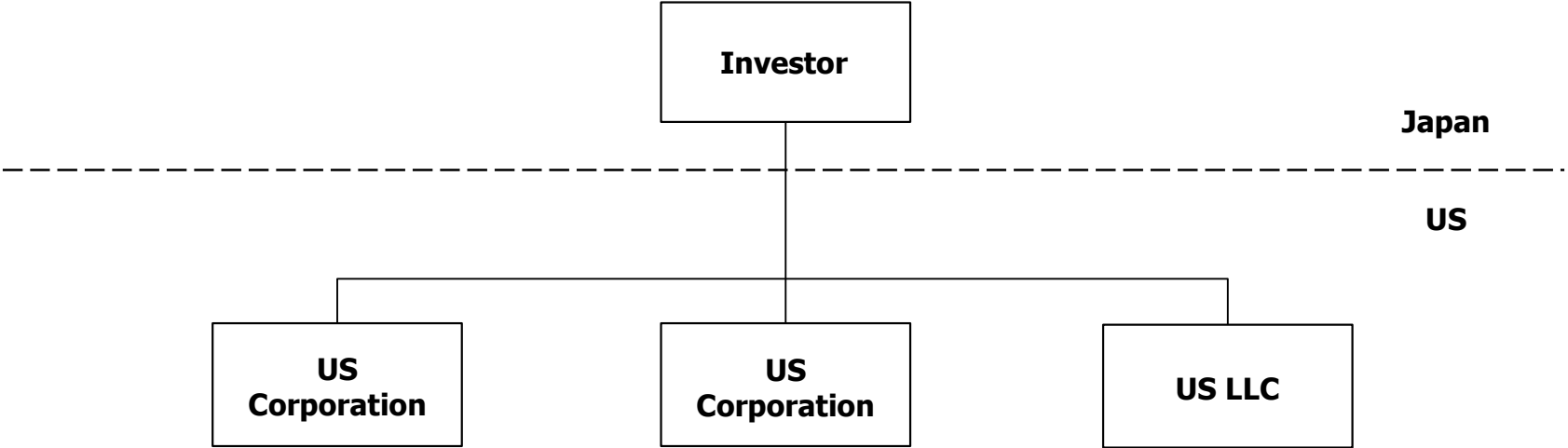


# **Investment Structure**

- (1) Direct investments from Japan**
- (2) Investments through US Corporate Fund**
- (3) Investments through US LP Fund**

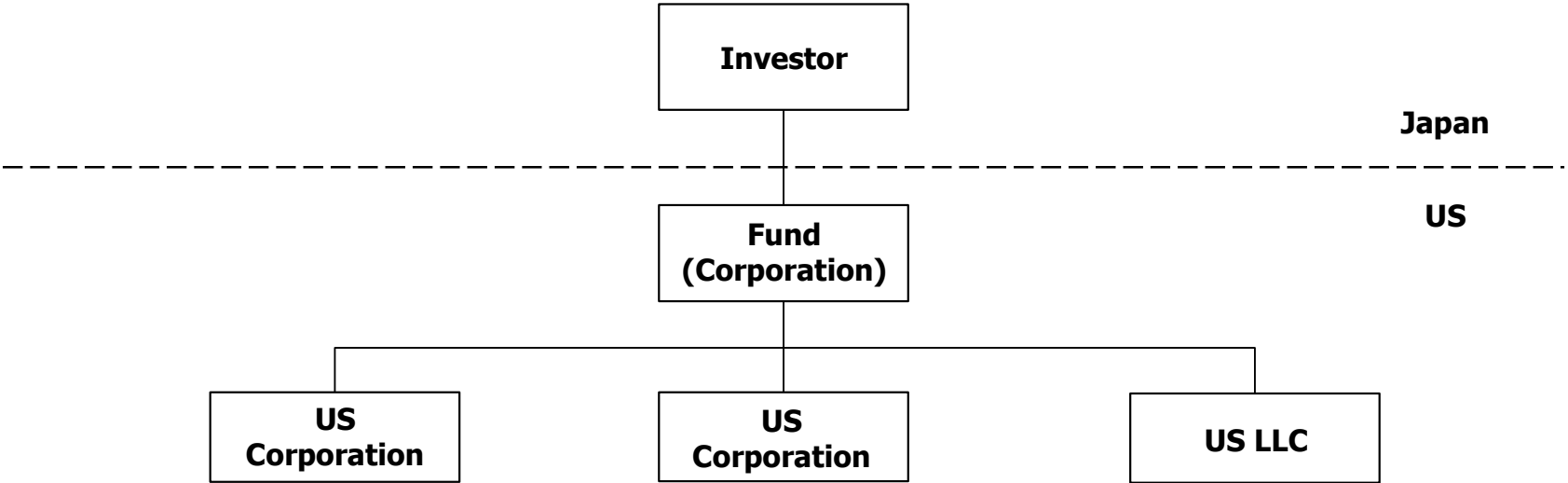
# Investment Structure

## (1) Direct Investments from Japan



# Investment Structure

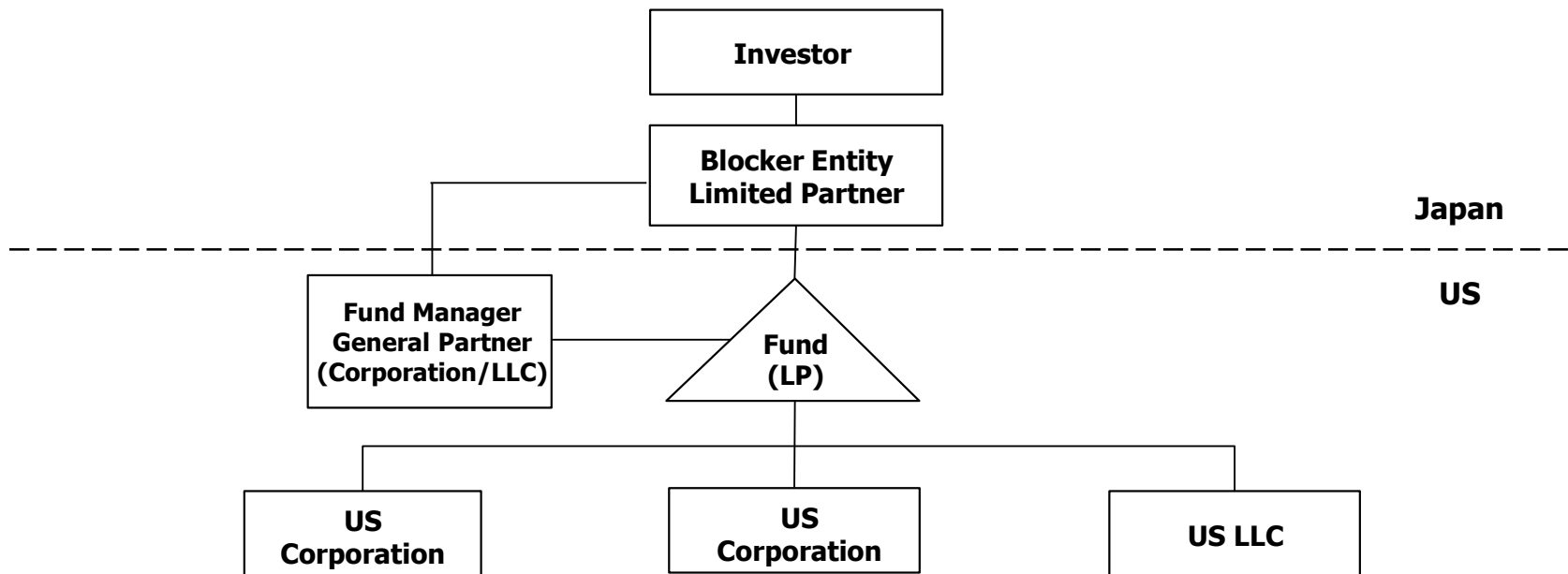
## (2) Investments via US Corporate Fund





# Investment Structure

## (3) Investments via US LP Fund



# Investment Structure

## Consideration for Each Structure

- Direct investment from Japan does not require burden of fund formation, but there is a risk that Japanese investors may be directly involved in disputes in the US (especially startup-related disputes)
- Although the investments through US Corporate Fund can mitigate the risk of Japanese investors being directly involved in disputes in the US, US Corporate Fund is treated as a corporation for US tax purposes and subject to federal corporate income tax with respect to dividends received by the US Corporate Fund from its portfolio companies
- US LP Fund is treated as a partnership for US tax purposes and not subject to federal corporate income tax on dividends received by US LP Fund from its portfolio companies
- Generally, dividends received by Japanese entities from US portfolio companies through US LP Funds are subject to 30% withholding tax, but this can be reduced to 10% or less pursuant to the Japan-US Tax Treaty
- Blocker entity may further reduce the risk of Japanese investors being subject to potential legal liability or tax audits

# Investment Structure

## Investments through US LP Fund

- General Partner has unlimited liability for LP Fund's obligations, while Limited Partner is liable within the scope of its investment amount
- General Partner operates LP Fund and make investments as the fund manager
- Initially, Limited Partner makes capital commitment, followed by capital contribution upon capital call when the Fund needs money to make investments
- In addition to fund management fee, certain percentage of the profits earned from the investments will be paid to General Partner as "carried interest" and then profits will be distributed to partners.
- Employment of people with knowledge and experience in fund operation and asset management as employees of General Partner (or secondment of such people to General Partner) may achieve favorable treatment for tax purposes

# 3. Fund Formation

## (1) Necessary Procedures in Japan

- **Incorporation of Blocker Entity**
- **Notification of Qualified Institutional Investors**
- **Notification of Specially Permitted Business for Qualified Institutional Investors, etc.**

# Establishment of Blocker Entity

## Advantage of Blocker Entity

- Insulate Japanese investors from taxation and audit risks in the US, and further reduce the risk of liability in connection with U.S. investments.
  - Because US LP Fund is treated as pass-through entity, dividends received by Blocker Entity from US portfolio companies through LP Fund are subject to US withholding tax; provided that Japan-U.S. Tax Treaty applies.
  - Even if the Internal Revenue Service (IRS) commenced an audit, Blocker Entity would be subject to the audit, rather than Japanese investor (a parent company of Blocker Entity).
  - The risk of Japanese investor being liable in connection with US investments can be further reduced by Blocker Entity becoming a member of fund manager (General Partner).
- By placing Blocker Entity, the impact of Japanese investor becoming a Qualified Institutional Investor (e.g., non-application of certain provisions for investor protection under the Financial Instruments and Exchange Act, posting on the FSA's website, etc.) can be avoided

# Establishment of Blocker Entity

- If we use a Japanese corporation as Blocker Entity, the Japan-US tax treaty will apply to dividends that Blocker Entity receives from US portfolio companies through US LP Fund
- Establishment of Japanese corporation
  - (1) Preparation (and notarization) of articles of incorporation, (2) capital corporation, and (3) corporate registration of incorporation
- Comparison between Kabushiki Kaisha (“KK”) and Godo Kaisha (“GK”)
  - Both KK and GK can become a Qualified Institutional Investor
  - GK does not require certification of articles of incorporation
  - Difference in registration tax (KK: JPY 150,000 at minimum, GK: JPY 60,000 at minimum)
  - GK is not subject to public notice requirement with respect to annual balance sheets
  - Differences in financing means and social credibility

# Financial Regulations in Japan

## Rules under Financial Instruments and Exchange Act

- LP fund interests are viewed as securities (collective investment scheme) under the Financial Instruments and Exchange Act.
- As General Partners of LP fund, act of investments of money contributed from Japanese investors (as Limited Partner) in securities or derivative rights is considered as Investment Management Business, even if investment activities are conducted outside of Japan
- Solicitation of Japanese investors by General Partner for investments in LP Funds is considered as Type 2 Financial Instruments Business
- As a general rule, registration as a Financial Instruments Business Operator is required in order to engage in Type 2 Financial Instruments Business and/or Investment Management Business
- As an exception, when certain requirements are satisfied under Specially Permitted Business for Qualified Institutional Investors, etc., General Partner may engage in solicitation for investments in LP Fund and investment management of LP Fund upon simple notification (Article 63 of the Financial Instruments and Exchange Act).

# **Specially Permitted Business for Qualified Institutional Investors, etc.**

## **Requirements for Specially Permitted Business for Qualified Institutional Investors, etc.**

- Business for at least 1 “Qualified Institutional Investor” and 49 or less “Other Qualified Investors”
  - (1) Qualified Institutional Investors: Investors specified by the Cabinet Office Ordinance with sophisticated knowledge and experience in securities investments
  - (2) Other Qualified Investors: Investors (other than Qualified Institutional Investors) with certain investment knowledge and experience or certain close relationship with the filing party
- In the aforementioned investment structure (Investments through US LP Fund), there is only one Limited Partner (i.e., Blocker Entity) and therefore, Blocker Entity needs to be a Qualified Institutional Investors at the time of Notification for Specially Permitted Business for Qualified Institutional Investors, etc.



# Qualified Institutional Investors

## Scope of Qualified Institutional Investors

- (1) Investors categorized as Qualified Institutional Investors without notification

Example: Japanese banks, insurance companies, securities companies, asset management companies, investment corporations, investment limited partnerships, etc.

- (2) Investors categorized as Qualified Institutional Investors upon notification

Investors who meet certain requirements (e.g., amount of assets requirement) can be categorized as Qualified Institutional Investors if they file notification with the Financial Services Agency (FSA)

Example: Corporations holding securities whose value is JPY 1 billion or more

- Once a corporation becomes a Qualified Institutional Investor, certain provisions regarding investor protection (e.g., delivery of pre-contract documents) under the Financial Instruments and Exchange Act will not apply
- A corporation newly established for CVC investment can become a Qualified Institutional Investor by holding securities whose value is JPY 1 billion or more and filing a notification with the FSA.

# Notification of Qualified Institutional Investors

- Notification form is simple and no supporting documents need to be submitted
  - Name and address of the filing party, category of Qualified Institutional Investor, total value of holding securities
- It is common to purchase Japanese Government Bonds (JGBs) in order to satisfy the requirement of holding securities whose value is JPY 1 billion or more
- Once notification of the Qualified Institutional Investor has been filed, the filing party can sell JGBs and the proceeds can be used to make investments in LP Fund
- The filing party will become a Qualified Institutional Investor from the first day of the second month following the month in which the notification has been filed
- Notification must be renewed every 2 years
- All Qualified Institutional Investors are listed on the FSA's website

# Notification of Specially Permitted Business for Qualified Institutional Investors, etc.

- Fund manager (General Partner) becomes a filing party
- Notification must be filed before execution of agreements by the Japanese investor (Limited Partner)
- Notification form and supporting documents can be prepared in Japanese or English
- Items to be included in the notification:
  - Name, address, capital amount, directors and officers of the filing party
  - Name and brief summary of the fund for which the filing party will solicit and manage, names of Qualified Institutional Investors to be solicited
  - If the filing party is a foreign corporation, the “Representative in Japan” needs to be appointed
- Supporting documents
  - Articles of Incorporation, affidavit (in lieu of corporate registration), and oath
  - Resume, certificate of residency and non-bankruptcy and identification (or affidavit in lieu of these documents), and oath with respect to directors and officers
- Preparation for filing generally takes around 2 weeks, and the notification becomes effective immediately

# **Specially Permitted Business for Qualified Institutional Investors, etc. - Obligations after Notification**

## **Amendment Notification**

- If there has been any change in items set out in the notification, amendment notification needs to be filed without delay

## **Preparation and Submission of Annual Business Report**

- Annual business report needs to be prepared and submitted to the FSA (Kanto Local Finance Bureau) within 3 months after the end of each fiscal year

## **Public Disclosure**

- Disclosure of document stating certain important items set out in the notification during the continuation of Specially Permitted Business for Qualified Institutional Investors, etc.
- Disclosure of explanatory document stating certain important items set out in the annual business report for one year from the date on which 4 months have passed since the end of each fiscal year
- Public disclosure shall be made through the website or by maintaining the documents in its Japan office for public inspection

# 3. Fund Formation

## (2) Necessary Procedures in US

- Formation of Fund Manager (General Partner)
- Formation LP Fund
- Other Filings (BEA and US Securities Law Filings)

# Formation of Fund Manager (General Partner)

The state of Delaware is preferred for incorporation and formation of entities in the US

## Advantages of Delaware

- Sophisticated corporate law: Delaware corporate law reflects latest US business developments, contains provisions to limit directors and officers' personal liability and indemnification, making it easier to attract talented people
- Court of Chancery: Delaware has "Court of Chancery" which specializes in corporate practice and has a high degree of business predictability thanks to dispute resolution by professional judges and the large number of precedents
- Prestige and Reputation: Majority of US publicly traded companies and over 60% of Fortune 500 companies are Delaware corporations
- Prompt processing by authorities: Filings in Delaware are processed promptly compared to other states
- Privacy: Delaware filings do not require much personal identifying information, which is desirable from perspective of mitigating risk of personal liability

# Formation of Fund Manager (General Partner)

## Incorporation of Delaware Corporation (C Corporation)

- Certificate of Incorporation filed in Delaware
- Preparation of By-laws
  - For privacy purposes, Certificate of Incorporation generally include minimum information, and most of the corporate information is included in By-laws
- Appointment of directors and officers (Delaware law is flexible in titles of officers)
- Indemnification Agreement between the company and its directors and officers
- If the company conducts business in a state other than Delaware, Foreign Qualification needs to be filed
- Other corporate filings in Delaware and other states in which the company conducts business (annual filings, etc.)

# Formation of Fund Manager (General Partner)

## Characteristics of an LLC (Limited Liability Company)

- Similarly to corporations, a Member of LLC is liable only within the scope of investment (limited liability)
- For US tax purposes, LLC has an option to be treated either as “corporation” or “pass-through entity”, subject to certain exceptions
- Certificate of Formation filed in Delaware
- Information about LLC is set out in LLC agreement, allowing flexible organizational structure
  - LLC can be either member-managed or manager-managed
  - Directors are not appointed. Appointment of officers is not legally required, but officers are usually appointed in practice
  - Fiduciary duty can be exempted under LLC agreement
- If the LLC conducts business in a state other than Delaware, Foreign Qualification needs to be filed
- Other filings in Delaware and other states in which the LLC conducts business (annual filings, etc.)



# Formation of LP Fund

## Limited Partnership

Limited Partnership consists of General Partner (unlimited liability) and Limited Partner (limited liability)

- Filing of Certificate of Formation in Delaware by General Partner
- Execution of Subscription Agreement
- Execution of Limited Partnership Agreement (“LPA”)

It is common to execute a simple LPA first, followed by Amended & Restated LPA that contains detailed terms and conditions with respect to fund management and profit distributions

- Prior to the execution of Subscription Agreement and LPA by Japanese investor (Limited Partner), Notification of Specially Permitted Business for Qualified Institutional Investors, etc. needs to be completed
- If the Limited Partnership conducts business in a state other than Delaware, Foreign Qualification needs to be filed
- Other filings in Delaware and other states in which the Limited Partnership conducts business (annual filings, etc.)

# Filings with Department of Commerce, Bureau of Economic Analysis (BEA)

- When a non-US corporation incorporates a US corporation as its subsidiary, it is necessary to file a notification with the Bureau of Economic Analysis (BEA) of the US Department of Commerce within 45 days of the incorporation
- Form BE-13 include the following:
  - Information regarding non-US parent company and its ultimate beneficiary owner
  - Information regarding business and finance of the US corporation
  - Business classification based on North American Industry Classification System (NAICS) codes
- If the amount of total investment is less than \$3,000,000, a simpler notification (BE-13 Claim for Exemption) is available
- Depending on investor's category etc., the filing may be exempted
- Failure to file may result in civil penalties (\$2,500 to \$32,500) and criminal penalties (imprisonment of not more than 1 year and/or fine of not more than \$10,000)

# Filings under US Securities Law

## Securities Act of 1933

- As a general rule, the registration with the Securities and Exchange Commission (SEC) is required for securities offerings in the US
- Exemption: Regulation D
  - Exemptions from registration with the SEC are available for certain small amount offerings and offerings to Accredited Investors.
  - When conducting offerings under Regulation D, filings of Form D enables us to avoid the risk of being challenged by the SEC for violations of the Securities Act (Safe Harbor Rule)
  - Registration with the SEC's online system, Electronic Data Gathering, Analysis, and Retrieval system (EDGAR), is required in order to make filings with the SEC (Form ID filing)
- Filings under state-level securities laws (Blue Sky laws) may also need to be considered

# 4. Key Takeaways

A photograph of a modern building's glass and metal facade at dusk. The building features a prominent, curved architectural element on the right side. The sky is a deep blue, and the building's lights are visible, creating a strong contrast with the dark sky. The overall mood is serene and architectural.

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# Key Takeaways

## Investment Structure

- LP Fund structure enables Japanese investors to reduce the risk of being directly involved in disputes in the US while enjoying tax benefits from pass-through taxation
- Blocker Entity may insulate Japanese investors from US taxation and audit risks, and further reduce the risk of liability exposure in connection with US investments

## Fund Formation Procedure

- Prior to execution of limited partnership agreement and subscription agreement by Japanese investor, it is necessary to complete Notification of Qualified Institutional Investor and Notification of Specially Permitted Business for Qualified Institutional Investors, etc. in Japan
- The state of Delaware is preferred for formation of fund managers and LP funds in the US
- In addition to corporate filings related to fund formation, the Bureau of Economic Analysis (BEA) filings and filings under the US securities law also need to be considered

# Next Webinar

## Corporate Venture Capital Investments in US Startups (Part 2) Getting the Deal Done: Key Terms and Considerations

Date: Thursday, February 16, 2023 / 4:00 pm PT

Thursday, February 16, 2023 / 7:00 pm PT

Friday, February 17, 2023 / 9:00 am JST

Presenters: Nancy Yamaguchi (San Francisco & Silicon Valley Offices)

Narumi Ito (San Francisco & Tokyo Offices)

Tomoko Fuminaga (Tokyo Office)

# Biography



## **Nancy Yamaguchi** **Partner**

San Francisco  
T +1.415.442.1242  
Silicon Valley  
T +1.650.843.7535

[nancy.yamaguchi@morganlewis.com](mailto:nancy.yamaguchi@morganlewis.com)

Nancy Yamaguchi advises global technology companies on cross-border mergers and acquisitions (M&A), strategic and venture capital investments, joint ventures, strategic alliances, technology transactions, and licensing. With more than 20 years of experience, Nancy is a trusted advisor to private and public multinational companies, especially those based in the United States and Japan, on all aspects of their corporate legal needs, including inbound and outbound M&A transactions.

Nancy is ranked Band 1 for Corporate/M&A: Deals in Asia by Chambers and recognized by clients as having “a business mind and tremendous attention to detail.” They commend her for being “excellent and speaking fluent Japanese but also able to translate the cultural context and is amazing when dealing with the Japanese government.” In addition, they note that “she is great at negotiation and everything legal and is extremely helpful in concluding multinational deals.”

### Education:

- Northwestern University Pritzker School of Law, J.D., cum laude
- Harvard University, A.M.
- Georgetown University, B.A.

# Biography



## **Narumi Ito**

### **Associate**

San Francisco

T +1.415.442.1274

Tokyo

t +81.3.4578.2631

[narumi.ito@morganlewis.com](mailto:narumi.ito@morganlewis.com)

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Narumi is licensed to practice law in Japan, California, and New York, and advises on various cross-border transactions and investments, particularly those based in Japan and the United States. He assists Japanese and non-Japanese companies on mergers and acquisitions, corporate venture capital (CVC) and other venture capital or strategic investments, other equity or debt financings, joint ventures, corporate formation and governance, foreign direct investment regulations, and privacy law, particularly in the semiconductor, banking, FinTech, IT, software, automotive, bio-pharmaceutical and medical technology (MedTech) industries. He also advises on Japan's financial regulatory matters with a particular focus on the formation, registration, and operation of investment funds.

Prior to joining Morgan Lewis, he worked at one of the largest law firms in Japan for approximately 10 years, and also worked at the Financial Services Agency as a legislative officer in charge of financial regulations, including the Financial Instruments and Exchange Act. In addition, he has experience in structuring structured finance transactions for a major Japanese securities firm.

Prior to joining Morgan Lewis, Narumi worked for nearly 10 years at one of the largest Japanese law firms. In addition, he served as a public officer of the Financial Services Agency of Japan, where he was in charge of drafting financial regulatory provisions such as the Financial Instruments and Exchange Act. He also has experience in working at a Japanese securities company, where he dealt with structuring complex finance transactions.

#### Education:

- University of California, Los Angeles School of Law, LL.M.
- University of Tokyo Faculty of Law, LL.B.



# Biography



**Tomoko Fuminaga**  
**Partner**

Tokyo

t +81.3.4578.2503

[tomoko.fuminaga@morganlewis.com](mailto:tomoko.fuminaga@morganlewis.com)

Tomoko Fuminaga, a licensed Japanese lawyer (bengoshi) partner, provides advice concerning financial regulatory and general corporate matters. With respect to fund matters, she counsels clients on structuring and distributing investment funds for Japanese investors, registering their Japan presence in Japan as financial instruments business operators, compliance, inspection preparation, and support and crisis management. In addition, she provides advice concerning market regulations, corporate governance, and shareholder proposals. She also counsels on establishing, licensing, and operating businesses for Japanese/foreign financial institutions not related to funds.

Additionally, Tomoko represents financial institutions and other clients on cross-border mergers and acquisitions transactions and provides legal services in connection with corporate and anti-monopoly law matters.

Tomoko began her practice as a licensed Japanese lawyer (Bengoshi) after working several years for a major Japanese bank. She is a bengoshi partner at the Morgan, Lewis & Bockius Law Offices/Morgan, Lewis & Bockius LLP (Foreign Law Joint Enterprise) in Japan.

Education:

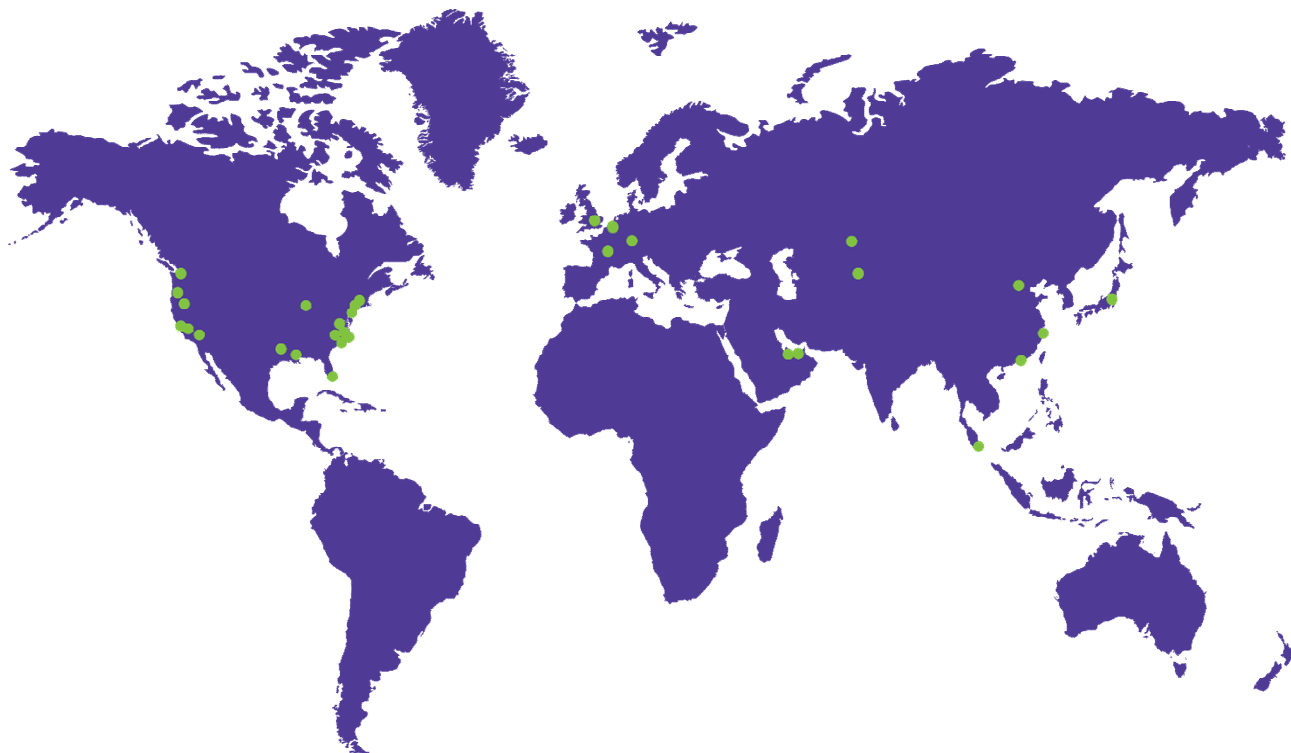
- New York University, LL.M.
- Waseda University, LL.B.

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