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Legal Issues in the Use of Blended Finance in Japan

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1. Introduction

"Blended Finance" is attracting global attention, and its use is spreading steadily. According to data from Convergence[1], a cumulative total of 1,123 blended financing transactions, totaling more than $213 billion, have been executed, with an annual average of approximately 85 financing events for each of the past 10 years and a median annual investment size of approximately $15 billion[2]. In addition, since the OECD Development Assistance Committee (DAC) approved Blended Finance Principles in 2017, there have been ongoing discussions on promotion of Blended Finance based on these principles, in the context of mobilizing private finance to resolve global issues, at the United Nations, EU, World Economic Forum, G20, and G7[3]. Blended Finance is attracting attention at the forum for international financial cooperation and is positioned as a key instrument for mobilizing finance to achieve SDGs.

Blended Finance has drawn increasing attention in Japan as well, with the promotion of "social finance" under the government's "New Form of Capitalism" and the growing attention to and interest in impact investment, for example, the guidelines for impact investment[4] published by the Financial Services Agency in March 2024 contain references to Blended Finance.

In the midst of this growing interest, there also is growing demand to handle legal issues relating to the spread of Blended Finance. In April 2024, the Global Alliance of Impact Lawyers (GAIL)[5], a group of lawyers in practice around the world, published research on worldwide trends in Blended Finance[6]. Thus, efforts are being made

[1] A worldwide organization of collectives and corporates dedicated to the use of blended finance and supplying funds to places in which funding is most needed. Member institutions include individual investors seeking to diversify their portfolios, corporations seeking capital, and public institutions and charitable foundations seeking to make further use of funds.

[2] Convergence "State of Blended Finance 2024" (April 2024). The fund structure is the most common, and, in particular, the use of private equity funds is increasing.

[3] OECD.org (https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/guidance-and-principles/)

[4] Financial Services Agency's "Basic Guidelines on Impact Investment (Impact Finance)" published in March 2024, at page 9 (https://www.fsa.go.jp/singi/impact/siryou/20240329/02.pdf)

[5] The Global Alliance of Impact Lawyers is a community of practitioners, including national lawyers, who are committed to having a positive impact on people and the global environment through legal practices, and to accelerating a just transition.

[6] GAIL, "Unlocking Legal Pathways for Blended Finance Case Studies and Global Insights," April 20, 2024. The report includes mapping of regulations and case studies on blended finance by more than 40 lawyers with expertise in advising on blended finance structures in 13 jurisdictions.

to consolidate knowledge, and to promote and disseminate Blended Finance from a legal perspective.

In this paper, authors who also participated in the research on Blended Finance published by GAIL discuss some legal considerations for the use of Blended Finance in Japan.

2. Overview of Blended Finance

(1) What is Blended Finance?

Blended Finance does not refer to a specific financial instrument or market, but is a financing method that focuses on the purpose and source of funding. Although there is no unified definition of Blended Finance, and the definition varies slightly depending on the organization and purpose, to date, Blended Finance has been used in two main contexts.

The first is development finance. An enormous investment, estimated at $4 trillion per year, is required to achieve the Sustainable Development Goals by 2030; thus, it is necessary to mobilize both private and public funds[7]. Attention has been focused on Blended Finance to mobilize additional financing for sustainable development in developing countries. In this context, the Blended Finance efforts are led by multinational development banks (MDBs) and development finance institutions (DFIs), primarily the Japan International Cooperation Agency (JICA). In the context of this development financing, Convergence defines Blended Finance as "the use of catalytic capital[8] from public or philanthropic sources to increase private sector investment in sustainable development."[9] [10]

The second context is impact finance. Unlike development finance, impact finance involves distinctive investments in domestic and overseas social enterprises and projects. As a contributor to concessional capital, it is assumed that a broader range of players, such as foundations and charities, will participate in this type of funding. For example, it has been noted that concessional finance has played an important role in impact investing, in terms of risk supplementation for general investors interested in impact investing and other factors[11], and concessional capital contributions have attracted investment from a broader range of investors. In this regard, Better Society Capital (formerly Big Society Capital), which uses dormant assets in the United

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7 United Nations Conference on Trade and Development, "World Investment Report 2023-Investing in Sustainable Energy for All," July 5, 2023, at page 30.

8 There is no unified definition of catalytic capital, but, for example, a report published by Better Society Capital defines catalytic capital as "investment into social purpose organisations and/or funds that is patient, risk-tolerant, concessionary, and flexible (or some combination thereof) in ways that can fill persistent capital gaps faced by social purpose organisations and social impact investment fund managers seeking new markets and attracting new capital." In addition, the relationship between concessional capital and catalytic capital, which is a risk-tolerant capital, it is arranged that (i) catalytic capital is made by the funding of concessional capital, and (ii) catalytic capital may be constituted by concessional capital and commercial capital (Tej Dhami & Mark O'Donnell "UK Catalytic Capital: GROWING PROVISION | CATALYSING IMPACT" (May 18, 2023)). However, in this paper, we do not address these distinctions.

9 Convergence has announced that it is focusing on Blended Finance in developing countries. (https://www.convergence.finance/blended-finance)

10 In the context of development finance, OECD also defines Blended Finance as "the strategic use of development finance to mobilize additional resources for sustainable development in developing countries." (https://www.oecd.org/en/about/programmes/clean-energy-finance-and-investment-mobilisation/blended-finance.html)

11 Financial Services Agency, "Basic Guidelines on Impact Investment (Impact Finance)" (March 2024) at page 4 footnote 5.

Kingdom and conducts social investment as a wholesaler of impact investment, views Blended Finance as an approach to addressing social and environmental issues through a combination of concessional capital with high risk tolerance and non-concessional capital that seeks market interest rate returns.[12]

The GAIL team explains that in the context of development finance, Blended Finance emphasizes the fit of capital contributed by investors pursuing market-level returns and attracting investors pursuing market-level returns through minimal concessionality, whereas in the context of impact finance blended finance tends to take a flexible approach to maximizing the efficiency of concessional capital with an emphasis on impact, which is reflected in differences in the content of due diligence and contract provisions[13].

In recent years, in Japan, there have been growing expectations that the private sector will utilize concessional capital-type blended finance in the context of contributions to impact investment, from perspectives such as lowering financing costs[14]. This paper reviews and summarizes the legal issues in Blended Finance, with a focus on the use of impact finance in Japan[15].

(2) Blended Finance Structure

It is appropriate to view Blended Finance as a structuring approach, rather than a particular investment or financial instrument. Generally, it is reasonable to classify Blended Finance into the following four categories[16].

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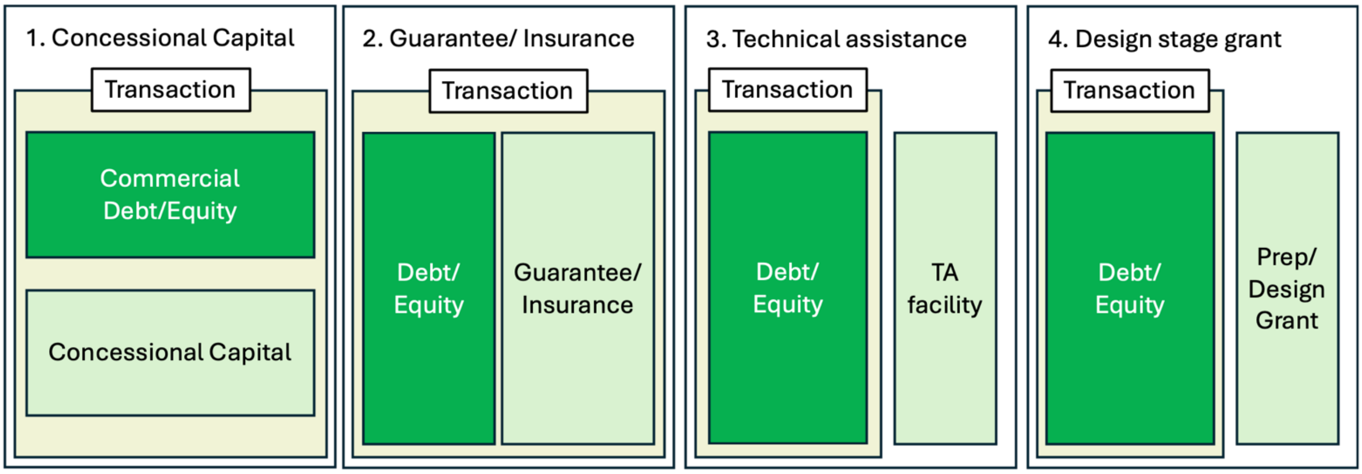
12 https://bettersocietycapital.com/information/blended-finance/

13 GAIL, "Unlocking Legal Pathways for Blended Finance Case Studies and Global Insights," April 20, 2024, at page 15-16.

14 The Financial Services Agency's "Basic Guidelines on Impact Investment (Impact Finance)" (March 2024) also notes, on page 9, that "it is important that such investment contribute more specifically to the social and environmental effects and the enhancement of corporate value generated by the companies and business activities of the companies in which the investment was made than if there were no investments." As an example of the content and contribution of this type of investment, the guidelines mention "the reduction of procurement costs through the use of diverse means of procurement such as blended finance, etc."

15 It is necessary to pay attention to various regulations, depending on the attributes of the investors in the Blended Finance and geographical factors, especially with regard to projects involving overseas development financing. The Basel Regulations apply to investments by commercial banks and other private financial institutions. Under the Basel Regulations, it is necessary to maintain certain capital adequacy ratios, in accordance with risk assets, and investment in Blended Finance may be counted as risk assets. In addition, DFI may be subject to specific regulations depending on the purpose of establishment and the nature of business performed. The regulations applicable to the relevant DFI need to be verified at the time of an investment in Blended Finance. In addition, geographical factors related to the legal system of the country or region in which the project will be implemented need to be considered. In particular, in recent years, regulations governing disclosures of climate change measures are being strengthened in many countries. If Blended Finance qualifies as a green project, disclosure of climate-related information to investors may be required.

16 This category is a compilation published by Convergence, but is common in general use. This type of financing mainly is relevant in the context of development financing, but can apply to impact financing also.



Concessional Capital	Guarantee/Risk Insurance	Technical Assistance Fund	Design Stage Grant
Public or philanthropic investors promote private investment by providing better terms than the market (including donations) to lower the overall cost of capital or provide an additional layer of protection to private investors.	Public or philanthropic investors facilitate the introduction of private investments by providing credit enhancement through guarantees or insurance at below-market terms.	Mitigates risks by providing grants for technical assistance to support the business environment and preparation for and implementation of projects, to enhance commercial viability and impact of development.	Subsidies are granted for design or preparation of a transaction, for example, a grant to cover the preparation or design phase of a project; this increases the feasibility of the project, etc., and leads to subsequent attraction of private capital.

According to Convergence's data[17], the most common form of Blended Finance is concessional capital, which accounts for more than 70% of Blended Finance transactions. These include capital and subordinated debt to assume first loss, subsidies at the investment phase, and capital and debt to bear risks with below-market financial returns to mobilize private sector investment. The next most common use is guarantees and risk insurance, but these account for only around 20% of all Blended Finance transactions. Nevertheless, in recent years, the use of both concessional capital and guarantee/risk insurance Blended Finance has been increasing[18].

3. Blended Finance Mechanisms

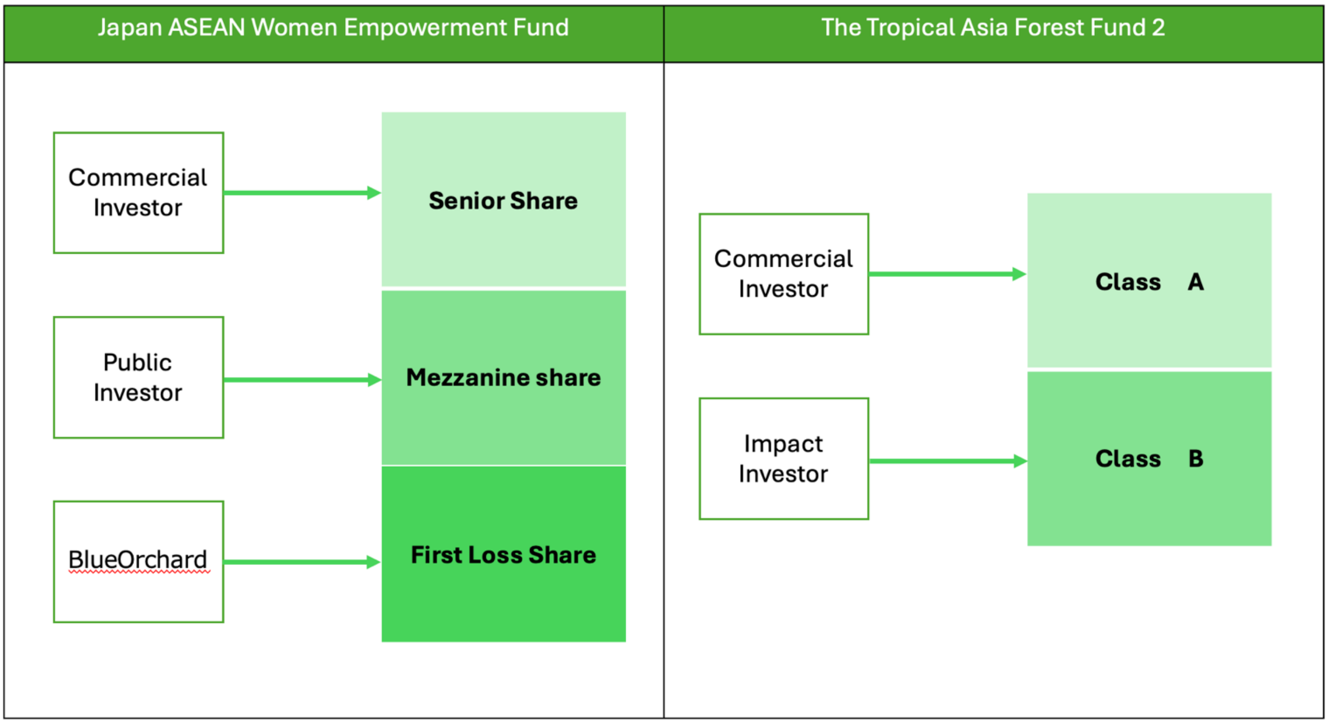
(1) How to design a blended finance structure?

Blended Finance is a mechanism that increases the amount of available funds by allowing investors to participate in seeking commercial returns through concessions by investors interested in public returns. This is why the structure is designed in terms of relatively risk-tolerant concessional funds covering the first loss portion. The method of funding, including concessional funds, covers debt instruments such as social impact bonds

17 https://www.convergence.finance/blended-finance

18 The SDG Loan Fund in Luxembourg is an example of the use of concessional capital and guarantees to attract large amounts of private capital. Of the $1.1 billion committed to the fund, $1.0 billion was contributed by private institutional investors, and the remaining $100 million was contributed by the Dutch Development Finance Corporation (FMO). Although FMO is in a position to take first losses in relation to institutional investors, it is designed to reduce the risk of loss through a $25 million guarantee to the SDG Loan Fund, provided by the John D. and Catherine T. MacArthur Foundation.

(SIBs)[19]; equity, such as stock, is the primary option, but grants and more concessional funding from charitable organizations, subsidies from governmental agencies, and tax incentives also play key roles[20]. Blended Finance is designed by combining these methods, or by creating a tiered structure, with different returns, using only a single method.



As an example, consider the Japan ASEAN Women Empowerment Fund, in which both JICA and the Japan Bank for International Cooperation (JBIC) invested in Luxembourg corporate funds, and equity was prioritized in senior, mezzanine, and first-loss shares. Market-rate commercial investors participated in the highest-priority senior shares, and public financial institutions (JICA and JBIC) invested in the second-tier mezzanine shares. BlueOrchard, which organizes and manages the fund, invests in the most subordinate tier of the fund, which bears first losses[21].

The Tropical Asia Forest Fund 2, structured in Singapore, divides its returns into two layers, and thus has succeeded in creating two types of investors, namely commercial investors (Class A) and impact investors (Class B), within the same fund[22].

Debt funds are designed as concessional funds through the use of unsecured or low value collateral, as well as lower interest rates, and by adjusting principal and interest payment dates (e.g., by establishing grace

19 For example, in Japan, the Toyonaka Giving Up Smoking Project and the Hiroshima Prefecture Cancer Screening Promotion SIB Fund utilize SIBs to provide funds of a different nature: loans from financial institutions, investments from foundations, and investments from individuals within the framework of public-private partnerships. These funds can be regarded as examples of Blended Finance in Japan.

20 See also: Tej Dhami & Mark O'Donnell, "UK Catalytic Capital: GROWING PROVISION | CATALYSING IMPACT" (May 2023) for a description of the common features, advantages, and disadvantages of these measures.

21 Convergence, "Japan ASEAN Women Empowerment Fund Case Study," March 2020, at page 3

22 Class A and Class B do not differ except for returns (Class A: 12%, Class B: 4%), and Class B investors are not necessarily responsible for absorbing first losses, but there is an agreement that 50% of the Class B equity will be used for impact-related activities (see: GAIL, "Unlocking Legal Pathways for Blended Finance Case Studies and Global Insights," April 20, 2024, at page 146).

periods or grace conditions after the loan is made).

In the case of equity funds, in addition to common shares, there may be differences in the amount and terms of dividends and the existence of redemption rights, through the use of class shares (preferred and subordinated shares).

When designing these products, it may be possible to combine the concept of revenue share/profit share, in which repayments or dividends are deferred until a certain amount of revenue is generated, and Capped Dividends, through which a certain upper limit on dividends is set to support sustainable business growth[23]. When using social impact bonds, it also is possible to incorporate an impact-linked concept, such as a reduction in interest rates when a specific impact target (outcome trigger) is achieved.

(2) Blended Finance Vehicles

There are several options for the legal vehicles used to consolidate funds and promote projects when implementing Blended Finance, and various approaches are used in different countries, depending on the applicable legal system[24]. In fact, according to Convergence data[25], the most common vehicles used in Blended Finance are funds (equity funds, debt funds, and funds of funds), and the use of trusts, joint stock companies, and impact bonds is also seen in some cases. However, since there are no laws in Japan that establish or regulate the vehicles themselves, it is assumed that the vehicle will be created in the form of a fund (investment limited partnership) or corporate entity, such as a joint stock company, and funds such as subsidy or grant of profit-making enterprises, charitable organizations, investment funds, development finance, and government funds are consolidated therein[26].

4. Legal Considerations in Blended Finance

(1) Investment agreement issues

When using Blended Finance, particular attention should be paid to various factors, including the different interests of the investors and the increased complexity of contractual relationships arising from the Blended Finance structure, as described above. For example, even if an entity is established in the form of a joint stock company and finances are aggregated, it is assumed that individual investment and loan agreements and shareholder agreements will be necessary, in addition to project agreements. The differences in interests may affect the governance structure, and it is assumed that certain investors will bear more risk and may or may not have differing interests in the degree of involvement in governance, such as the right to elect directors, and in reporting requirements, such as ensuring consistency with missions and reporting of impact KPI, as well as in

23 There are two methods for the Capped Dividend structure: an annual dividend cap, and establishment of a cap on the returns earned by the investors, both of which are used overseas.

24 See: GAIL, "Unlocking Legal Pathways for Blended Finance Case Studies and Global Insights," 20 April 2024, at page 24, for more information on vehicles available for blended financing in different countries.

25 https://www.convergence.finance/blended-finance

26 As Blended Finance has the same financial documents as concessional funds and for-profit funds, it has been pointed out that tax and accounting procedures may become more complicated in different countries (page 27 of the GAIL report). Consideration should be given to each individual situation, taking into account the tax and accounting treatment in the relevant country or countries.

the methods of determining the use of funds, and these issues need to be reflected in relevant agreements. This needs to be sorted out in the early stages of structuring and term sheet discussions, with experts being commissioned on a case-by-case basis.

(2) Issues when forming funds

Two cases are envisaged in which Blended Finance is used by a fund: (i) when Blended Finance is used to raise funds at the fund level, and (ii) when Blended Finance is used at the level of investment execution by the fund. As the issues relating to option (ii) are the same as those relating to investment agreements, this section focuses on the context of option (i)[27]. In addition, when setting up a fund in Japan, the most promising option is an investment limited partnership under the Limited Partnership Act for Investment, so this paper focuses on investment limited partnerships as fund vehicles.

a) Issues under the Financial Instruments and Exchange Act

In principle, interests in partnership-type funds are deemed securities under Japanese law (Financial Instruments and Exchange Act (FIEA), Article 2(2)(v)), so (again, in principle) the fund operator is required to register as a Type II financial instruments business operator ("Type II FIBO") if it solicits the acquisition of interests in the funds on its own (FIEA, Article 2(8)(vii)(f)). In addition, if the fund operator intends to manage the money invested in the fund directly, the fund operator must register as an investment management business operator ("IMBO") (FIEA, Article 2(8)(xv)(c)). Therefore, when setting up a fund using Blended Finance, in principle it is necessary for the operator of the partnership that will aggregate the funds and promote the project to register as a Type II FIBO and/or IMBO under the FIEA, based on its planned activities. However, if the investors in the fund include one or more qualified institutional investors and 49 or fewer investors subject to Specially Permitted Services (Order for Enforcement of the Financial Instruments and Exchange Act, Article 17-12(4)(ii)) and meet other statutory requirements, the fund operator can solicit interests in the fund and manage the fund by filing a notification of Specially-Permitted Business for Qualified Institutional Investors, rather than obtaining a Type II FIBO or IMBO registration. In the event of registration or notification under the FIEA, the fund operator must comply with various regulations set forth in the FIEA, including a prohibition on compensation for loss, the principle of suitability, and the regulations on reciprocal transactions between proprietary trading and assets under management.

b) Fund agreement issues

As an initial matter, it is necessary to determine whether it is possible for investors who pursue market-level returns and investors who are risk-conscious, such as those who contribute concessional funds, to join the same fund as limited partners with junior and senior relationships. Since the "cash value of one unit of contributions must be uniform" (Limited Partnership Act for Investment, Article 6, Paragraph 3), it can be widely construed that the equity interests in an investment limited partnership must be uniform. However, according to the wording of that the same paragraph, it also is straightforward to consider that it specifies only a uniform

27 The hypothetical use of Blended Finance in the fund in this paper assumes that investors who become limited partners will receive dividends of profits or distributions of assets relating to the invested business in excess of the amount of their contributions. Accordingly, a separate examination is required for a donated Blended Finance that does not enjoy any return from the fund.

amount of one unit investments, and that it is not necessary that the content of the shares be uniform[28]. In addition, given the published opinion that the purpose of this provision is to require uniformity of amounts for purposes of convenient equity calculations[29], it is considered possible to establish the content of partnership interests according to the risk orientation of each investor[30]. Thus, for example, a tiered hierarchy of junior and senior limited partners could be set up, with senior investors receiving priority in distribution of returns from the fund, while junior investors receive distributions in an amount equivalent to their principal after the senior investors have received distributions equivalent to the amount of their investment performance. It is expected that this waterfall structure will be adopted with regard to distribution provisions. Similarly, liquidation provisions need to be established in line with the distribution terms, and provisions relating to ownership interests in fund assets and shares of profits and losses need to be adjusted in accordance with the junior-senior structure of the fund.

It also is possible to differentiate between the rights of each limited partner, not only in terms of financial return, but also in terms of involvement in governance of the fund, including the investment committee and advisory committee, and reporting transparency, for example, by establishing favorable terms for investors in concessional funds who are taking higher risks. Consideration also can be given to clauses requiring refunds of investments in concessionary funds if the fund’s investment activity deviates from the original purpose defined in the agreement, or linking the remuneration of the general partner with the fund’s achievement of impact KPIs.

5. Toward Wider Use of Blended Finance

In this paper, we have offered an overview of Blended Finance mechanisms and relevant legal issues. Some major financial institutions have announced their intent to use Blended Finance, and it is expected that, in the future, increasing attention will be paid to international trends calling for corporate social responsibility and sustainability efforts.

However, Blended Finance is not actively used in Japan at the present time, and obstacles to its use have been pointed out, including the complexity of the Blended Finance structure, the need to customize it on a project-by-project basis, and the need to coordinate the interests of various stakeholders[31]. In this respect, it will be necessary to accumulate and share practical knowledge of realistic structures, for example, by using structures that are appropriate to the size of the transaction.

In addition, Japan has few concessional fund providers, which play an important role in the implementation of Blended Finance. To expand the use of Blended Finance, it is crucial to increase the number of players that can contribute concessional funds from the private sector, such as charities, angel investors, and family trusts, as well as local authorities and public financial institutions. Rather than relying solely on the decisions of individual players to expand Blended Finance, it will be necessary to consider policy-based support, such as

28 Nishimura Asahi Law Office, "The Finance Law Grand [Complete Revision] (Part 1)" (August 2017), at page 357.

29 Ministry of Economy, Trade and Industry " Explanation of Separate Articles for Limited Partnership Act for Investment" (revised June 1, 2005), at page 45.

30 However, if there is a transfer of economic profits from certain investors to others, there may be situations in which tax considerations are necessary, for example, to determine whether the transfer may be deemed a gift or donation.

31 See comments (https://thegiin.org/blended-finance-working-group/) in Global Impact Investing Network (GIIN).

providing tax advantages for certain investments, as occurs the UK and the U.S.[32]

In the UK, Better Society Capital, a wholesaler of impact investments that utilizes dormant assets, has a strong presence in the Blended Finance sphere; wholesaler impact funds like Better Society Capital are expected to be important catalysts for projects, as concessional fund providers. Better Society Capital also is actively involved in efforts to promote Blended Finance, for example, by disseminating information on Blended Finance. In Japan, it is expected that the Japan Network for Public Interest Activities (JANPIA), an organization that utilizes dormant assets, play a corresponding role in the future.

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32 The U.K. Governments have introduced tax breaks to promote specific socially influential investments, such as Community Investment Tax Relief. In the United States, tax incentive programmes such as Qualified Opportunity Zones, New Markets Tax Credit, and Renewable Energy Tax Credits, as well as charitable contributions eligible for traditional tax credits, also serve to guide capitalization.