

Cross-listings of ETFs

Kei Ito and Yusuke Motoyanagi of Nishimura & Asahi track developments following the 2007 amendments to the TSE's securities regulations

In November 2007, the amended Securities Listing Regulations of the Tokyo Stock Exchange (TSE) took effect, accepting cross-listings of exchange-traded funds (ETFs) formed in a foreign country. Following that, beneficiary certificates of Kodex200 ETF were newly listed on the TSE on November 19 2007, and SPDR(r) Gold Shares, being beneficiary certificates of SPDR(r) Gold Trust, were newly listed on the TSE on June 30 2008. These are Japan's first direct cross-listings of foreign ETFs tracking a stock index (Kodex200 ETF) and a gold price (SPDR(r) Gold Shares).

What is an ETF?

An ETF is a fund that typically tracks an index such as a stock or bond market index. Units of an ETF can be bought and sold at any time through a securities exchange, just like shares of a company.

In Japan, ETFs are usually formed as investment trusts (a trust-type mutual fund) and are sometimes described as investment trusts listed on a securities exchange. However, this description can be incorrect because some ETFs do not fall within the definition of investment trust or foreign investment trust under the Financial Instruments and Exchange Act (FIEA) and the Investment Trust and Investment Corporation Act (ITA). Indeed, SPDR(r) Gold Trust is not a foreign investment trust, though it will fall within the definition of a foreign investment trust after certain

amendments take effect on December 12 2008.

Three types of foreign ETFs

Under the TSE's Securities Listing Regulations, a Foreign ETF (*gaikoku-ETF*) is defined to include both: (i) beneficiary certificates of a foreign investment trust (*gaikoku-toshi-shintaku*, a trust-type mutual fund formed outside Japan); and (ii) interests in a foreign investment corporation (*gaikoku-toshi-houjin*, a corporate-type mutual fund formed outside Japan), in either case aiming to track a specific index. Under the same regulations, a Foreign spot commodity ETF (*gaikoku-shohin-genbutugata-ETF*) is defined as beneficiary securities of a foreign beneficiary securities-issuing trust (*juekishoken-hakko-shintaku*) where: (i) it aims to track a specific commodity spot price; and (ii) each beneficial owner of such interests has equal rights on a pro rata basis.

Legal requirements (including offering regulations and disclosure obligations) and the TSE's listing requirements and procedures differ among Foreign ETFs (foreign investment trusts), Foreign ETFs (foreign investment corporations) and Foreign spot commodity ETFs.

Because the Kodex200 ETF is a foreign investment trust as defined in the FIEA and the ITA, it is subject to the rules applicable to a Foreign ETF. Because the SPDR(r) Gold Trust is a foreign beneficiary securities-issuing trust as defined in the FIEA, it is subject to the rules applicable to a Foreign spot commodity ETF (though, as noted, it will come within the definition of a Foreign ETF after certain amendments take effect on December 12 2008).

Disclosure obligations

Securities registration statement

In general, under the FIEA, in the event securities are offered in Japan in a public offering, either on a primary basis (*boshu*) or a secondary basis (*uridashi*), the issuer must file a securities registration statement (SRS) with the relevant authority with respect to the proposed offering in Japan. An SRS becomes effective, at the earliest, 16 days after filing,

and the offeror may not effect sales until the SRS becomes effective. Thus, it is necessary that the SRS becomes effective before the relevant subscription period.

However, if units of an ETF

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can be created only by authorised participants outside Japan, there is no solicitation of newly issued securities in Japan. Because solicitation is an element of *boshu* (public offering on a primary basis), there is no *boshu* in Japan and no SRS is required for the offering of newly issued units of the ETF. In addition, *uridashi* (public offering on a secondary basis) under the FIEA means solicitation for application to sell or

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purchase already issued securities made to 50 or more persons on uniform terms. To the extent that ETFs are traded on a stock exchange, there cannot be a solicitation on uniform terms and there is thus no *uridashi* of the units of the ETF. As a result, in many cases no SRS filing is required.

Because only authorised participants outside Japan can create units of Kodex200 ETFs or SPDR(r) Gold Shares, no SRS was filed upon the listing of either.

Filing of a securities report on the listing day

Even if no SRS is required, the issuer of securities listed on a financial instruments exchange is obliged, upon listing, to file a securities report (SR). Therefore the issuer of units of an ETF must file an SR with the relevant

authority on the listing day (concerning the identity of the issuer).

The SR must provide certain detailed information including: (i) the investment strategy, history, management structure, risk factors, performance and audited financial statements of the fund; (ii) the management structure and audited financial statements of the manager; and (iii) outlines of the supervisory authorities of the fund, of the law applicable to the fund and of the investment trust system in the home country.

Although some information can be prepared based on the ETF's prospectus or trust deed, it is quite likely that information not disclosed in the home country must be disclosed in Japan. Particularly, under the "outline of the investment trust system in the home country" sec-

tion, the issuer must (with the assistance of a home country lawyer) describe the entire investment trust system in the home country.

In general, financial statements to be attached to an SR must be prepared in accordance with Japanese generally accepted accounting principles (GAAP). However, in cases where the relevant Japanese authority approves, financial statements can be prepared in accordance with the GAAP of a foreign country.

The SR is filed through the Electronic Disclosure for Investors Network (EDINET), an electronic filing system.

Continuous disclosure

After a listing of units of an ETF, the issuer becomes subject to the FIEA's continuous disclosure obligations and must file an SR for each fiscal year. The SR must be filed with the relevant authority, in general, within six months after the expiration of each accounting period.

In addition, if a fund's accounting period exceeds six months, the issuer must also file a semiannual report within three months after the expiration of the first six months, in the manner specified by the relevant Cabinet Office Ordinance. The mandatory contents for a semiannual report are less comprehensive than for the SR.

Moreover, immediately after the occurrence of certain material events (including certain offerings of the listed securities, changes in the management company, trustee or other material related parties and changes to the material terms of the trust deed), the issuer must file an extraordinary report in the manner specified by the relevant Cabinet Office Ordinance.

English disclosure

Under the FIEA, a foreign company subject to the continuous disclosure

obligations may, instead of filing certain disclosure documents, file corresponding documents prepared in the English language. This English disclosure may be made in respect of an SR or semiannual report, but not extraordinary reports.

For English disclosure, only certain English language reports are eligible, and these must be disclosed in a foreign country in the English language pursuant to law or regulation, or the regulation of a financial instruments exchange, in the jurisdiction where the relevant company or fund is established. In addition, it is necessary that the Commissioner of the Financial Services Agency of Japan deems that the filing of the English language report by the issuer does not offend Japanese public interest and does not harm Japan's investors. This requirement is normally examined on a jurisdiction-by-jurisdiction basis, but an examination may also be performed specifically with respect to the relevant issuer.

In the case of English disclosure, the issuer of the securities is required to file the following documents in addition to the English language report:

- a Japanese-language summary of certain important items specified in the relevant Cabinet Office Ordinance that must be described in an SR (Important Items) and that are described in the English reports, such as the structure of the fund, investment policy, investment risks, commissions, taxes, the status of the investment portfolio and financial statements of the fund;
- where any of the Important Items are not described in the English language report, Japanese-language documents describing such items;
- documents in either the Japanese or English language describing the items that must be described

in the SR (other than the Important Items) but that are not described in the English report; and

- a table that compares the items actually described in the English report and the items that must be described in the SR.

Who is the issuer of the ETF?

Under the FIEA, an issuer is defined as a person who issues, or intends to issue, securities. As to an ETF, it is generally understood that: (i) if there is a management company that is the trust settlor and that instructs investment management, it is the issuer of the ETF; and (ii) if the trustee has discretion in managing the trust, it is the issuer of the ETF.

Regarding foreign ETFs, a sponsor often executes an agreement with the trustee as a planner or organiser of the ETF and has the power to make decisions on important matters, such as the dismissal of the trustee. Usually, the sponsor does not become the trust settlor, and the trustee is granted discretion in conducting daily operations. Although this arguably indicates that the sponsor does not fall within the condition of (i), above, the position of the sponsor is in fact similar to that of the management company there described, as it may be said that any actions by the trustee are conducted in accordance with the sponsor's intention. Therefore, although this depends on all the relevant facts, it seems that the sponsor, as de facto management company, will usually be treated as the issuer and will thus be the party

subject to the FIEA's continuous disclosure obligations.

In this case, information concerning the sponsor (including financial statements) is to be disclosed in an SR. Therefore, an audit report on the sponsor's financial statements by a certified public accountant or accounting firm is required. However, in many cases, no such audit report exists because it is not required in the home country. Accordingly, it will often be necessary to prepare an audit report specifically for disclosure in Japan.

Timely disclosure Matters to be disclosed

Following the listing, the issuer of a foreign ETF will be required to disclose certain matters, as set forth in the rules of the relevant financial instruments exchange. Among other items, the issuer must, in general,

disclose the following each trading day:

- the number of units issued;
- the total net asset value (NAV) of the fund and the NAV per unit; and
- the deviation ratio

between the NAV per unit and the closing prices of the target index.

In addition, the issuer of a foreign ETF must disclose certain other items, including a determination of annual and semiannual earnings, amendment of the trust deed and the occurrence of material events related to the management company or the trustee.

Procedures

Disclosures, under the regulations of a

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financial instruments exchange, must be made through the Timely Disclosure network (TDnet) established by the TSE, which requires the use of a personal computer on which a certain electronic certificate, provided by the TSE, is installed to identify such computer. The TSE permits the installation of such a certificate on only one computer, which must be located in Japan. Therefore, if the management company has no office in Japan, it must delegate the handling of the disclosure through TDnet to someone in Japan.

Custodian

All units listed and traded on a financial instruments exchange in Japan must be deposited into an account maintained by Japan Securities

Depository Center Inc (JASDEC), through an intermediary or otherwise, at a depository company in the home country.

Settlement between clients in Japan of the same securities company will be made by transfer between these clients' respective accounts at such securities company. Settlement between clients of different securities companies will be made by transfer between these clients' respective securities company's accounts at JASDEC. Therefore, such transfers will not affect the number of units held by JASDEC in its account at the depository company in the home country. However, any transfer of units to or from outside of Japan may affect the number of units held by JASDEC in that account.

In Japan, JASDEC will entrust certain administrative services con-

cerning a foreign ETF to a Japanese trust bank, including the preparation and maintenance of a detailed list of unit holders, services for treaty-based tax reductions on distributions, receipt of amounts distributed by the fund and conversion thereof into Japanese yen, collection and payment of Japanese withholding income tax (including local tax) thereon and distribution of funds received to unit holders.

Preparation for listing

Listing documents

Listing applications and other documents, including a draft of the SR to be filed on the listing date, must be submitted to a financial instruments exchange at least one month before the listing date. Some documents

must be executed by both the management company and trustee.

EDINET registration

For filings through EDINET, registration of the issuer is needed before the listing date, on which it must file an SR.

For this purpose, articles of incorporation of the issuer and certain other documents must be submitted.

Financial instruments business operators

Under the FIEA, no person may, without proper registration, engage in any financial instruments business, as defined under the FIEA. This includes, in general: (i) conducting an offering or private placement of securities; and (ii) acting as an intermediary for the sale and purchase of securities.

In Japan, soliciting the creation of units of an ETF falls within (i) above. Therefore, the issuer may not conduct such solicitation without proper registration. If, however, there is no solicitation by the issuer, it need not be registered. As discussed above, so long as the units may be created only by authorised participants outside Japan, there is no solicitation by the issuer in Japan and, therefore, no registration will be required. Furthermore, even if units are capable of being created in Japan, to the extent that the solicitation for their creation is entirely delegated to registered financial instruments business firms, the issuer need not be registered.

Under the FIEA, acting as an intermediary is broadly interpreted to include motivating someone to sell or purchase the securities. Even if the issuer enters no agreements regarding the sale and purchase of the units, an issuer's activities in arousing interest in the ETF can easily fall within that category. Hence, to avoid a registration requirement the issuer must be careful that its marketing activities cannot be so categorised.

Recent revision of the Cabinet Order

On December 12 2008, amendments to the ITA and the Order for Enforcement of the Investment Trust and Investment Corporation Act will take effect. At present, the definition of an investment trust under the ITA is limited to trusts investing in specified assets. The amendment to the Order for Enforcement will expand the definition of specified assets to include commodities and certain derivatives. In this regard, the SPDR(r) Gold Trust will fall within the definition of a foreign investment trust under the FIEA and the ITA, as well as that of a Foreign ETF under the TSE's Securities Listing Regulations.

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