

**Exchange-Traded Notes (ETNs) in Japan  
- Introduction to the recently  
published ETN listing rules -**

**1. Debut of ETNs in Japan**

In Japan, a market for Exchange-Traded Funds (“ETFs”) has rapidly emerged over the past few years. Currently, Exchange-Traded Notes (“ETNs”), a product that we have not seen until now, are expected to be listed on Japanese exchanges. On March 31, 2011, the Tokyo Stock Exchange (“TSE”) published listing rules for ETNs. In addition, the Osaka Stock Exchange (“OSE”) has recently called for comments on proposed rules for ETNs. In this newsletter, we discuss the structure and listing rules for Japanese ETNs.

**2. ETN Structure in Japan**

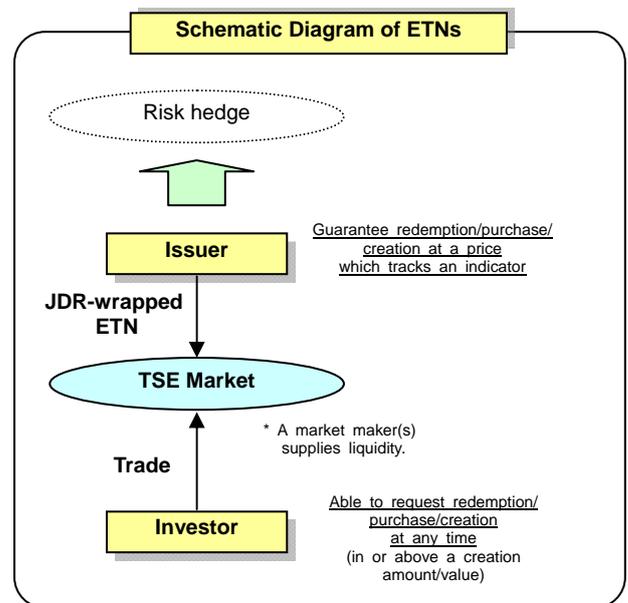
**(1) What is an ETN?**

ETNs are financial instruments that are similar to ETFs and intended to track the performance of the underlying indices, such as equity, fixed income and commodity indices. However, as the name implies, ETNs are corporate bonds issued by financial institutions, and they have no underlying assets as compared to ETFs. ETN issuers will guarantee performance that is linked to the underlying indices through redemption prices that are linked to such indices. Hence, in the case of ETNs, tracking errors with regard to the underlying indices are unlikely to occur (i.e., financial institutions issuing ETNs will assume the risks with regard to such tracking errors), and ETNs can track indices that are not easily accessed in the form of ETFs, such as emerging market products and single commodities, to the extent that the issuers assume/manage such risks. On the other hand, as compared to ETF investors, ETN investors will be exposed to the issuers’ credit risk since ETNs are corporate bonds.

**(2) A JDR structure is required for an ETN listing in Japan**

According to the TSE listing rules as well as the proposed OSE listing rules, ETNs in Japan will be listed in the form of Japanese Depository Receipts (“JDRs”). JDRs are beneficiary certificates issued by trust banks in exchange for (foreign) ETNs as trust assets, pursuant to the Trust Law of Japan, and they are treated as *securities* under the Financial Instruments and Exchange Act of Japan (“FIEA”), one of the building blocks of financial law in Japan. Figure 1, which was published by the TSE, illustrates the structure of a JDR-wrapped ETN to be listed on the TSE.

**Figure 1 - JDR-wrapped ETN Structure**



[Source: TSE]

**3. Overview of the Japanese listing rules for ETNs**

Below, we mainly discuss the TSE listing rules for ETNs, and refer to the proposed OSE listing rules to the extent necessary.

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**(1) Only foreign ETNs are eligible for listing**

The ETNs eligible for listing on the TSE are “foreign index linked securities.” In a nutshell, “foreign index linked securities” means foreign ETNs.<sup>i</sup> These ETNs must have the characteristics of a corporate bond (*shasai*) as defined under the FIEA.<sup>ii</sup> As discussed in Section 2(2), foreign ETNs will be listed on exchanges in the form of JDRs.

**(2) Listing criteria - focusing on the creditworthiness of ETN issuers**

Table 1 below summarizes the TSE listing criteria applicable to ETNs. Since the creditworthiness of ETN issuers is critical as described above, there are financial condition requirements such as minimum net assets, capital ratio, and credit rating. Compared with the TSE, under the current proposed rules, the OSE would require only net assets of ¥20 billion or more for ETN issuers, but two or more credit ratings that satisfy the level determined by the OSE. This may be a reflection of the different views of each stock exchange with regard to credit risk assessment for ETN issuers.

**Table 1 - Summary of the TSE listing criteria for ETNs**

|                            | <b>Requirements</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|----------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Issuer</b>              | <ul style="list-style-type: none"> <li>• A registered financial institution or a financial instruments business operator as defined in the FIEA,<sup>iii</sup> or their equivalent</li> <li>• Continuous business track record of three years or more</li> <li>• No misstatement in financial statements and obtainment of an auditor's unqualified fairness opinion on such financial statements during the most recent two years</li> </ul>                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Financial condition</b> | <ul style="list-style-type: none"> <li>• Amount of net assets is ¥500 billion or more</li> <li>• Shareholder capital ratio of more than 8% for registered financial institutions, solvency margin ratio of more than 400% for insurance companies, regulatory capital ratio of more than 200% for financial instruments business operators, or an adequate capital ratio determined by the TSE for entities other than the above</li> <li>• Credit rating of A- (single A minus) or above rated by a credit rating agency</li> </ul>                                                                                                                                                                                                                                                                                 |
| <b>Productivity</b>        | <ul style="list-style-type: none"> <li>• The following conditions must be stipulated in the ETN documents: <ul style="list-style-type: none"> <li>✓ Redemption/repurchase requests, with regard to a quantity or amount that is equal to or above a certain level, are acceptable every five or less business days</li> <li>✓ Redemption/repurchase prices are determined in accordance with specified indices</li> <li>✓ An appropriate guarantee is provided (if a guarantor exists)</li> </ul> </li> <li>• Eligibility of underlying indices</li> <li>• The remaining term up to the ETN's final maturity is more than five years</li> <li>• The sum of unredeemed ETNs and the scheduled issuance amount of the ETNs at the listing does not exceed 25% of the amount of net assets of the ETN issuer</li> </ul> |
| <b>Others</b>              | <ul style="list-style-type: none"> <li>• Several requirements regarding liquidity, treatment of the book-entry system, cross-listings on foreign financial instruments exchanges, and execution of trust contracts regarding JDRs</li> <li>• Requirements for public interest and investors' protection</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |

*Note: The above requirements are abstracts from the TSE listing rules for ETNs and are applicable to a guarantor (if any).*

[Sources: TSE's published documents; N&A]

**(3) Daily and timely disclosure requirements**

As with ETFs, there are daily and timely disclosure requirements for ETNs. Daily disclosure requirements include the number of listed units of ETNs, redemption price (both in total and per unit), and daily deviation rate between the redemption price of the ETNs per unit and the underlying indices.

Timely disclosure requirements include information concerning ETN issuers, such as secondary offerings, mergers and acquisitions, bankruptcy events, events of default, changes to the names of ETNs or the certified public accountants in financial statements regarding ETNs, notes regarding going concerns in financial statements, extraordinary suspension of ETN issuance/redemption, certain administrative sanctions against ETN issuers pursuant to laws, and credit rating changes of ETN issuers. There is also a catch-all clause in order to include events that materially influence investors' decisions. In addition to the above, issuers are required to disclose their financial results and creditworthiness.

**(4) Delisting**

The removal of an ETN listing will occur, for instance, in cases where issuers do not satisfy certain of the above listing criteria (e.g., the financial condition criteria taking into consideration certain cure periods), engage in material misconduct such as material misstatements or delay in submitting securities reports (as required by the FIEA), or other events that lead to the removal of their listing occur.

**4. Conclusion**

The Japanese market for exchange-traded products is now moving to the second stage with over 100 ETFs having been listed on exchanges. We expect that ETNs will be a catalyst to further boost the exchange-traded product market in Japan, and hope that this newsletter will be helpful for foreign ETN issuers who are considering a listing in Japan.

<sup>i</sup> According to the TSE's responses to public comments made earlier this year, domestic financial institutions will be able to "issue" ETNs that are eligible for listing on the TSE by utilizing the following structure: the ETN issuers are foreign subsidiaries of domestic financial institutions or special purpose vehicles established overseas, and the domestic institutions are guarantors for the ETNs.

<sup>ii</sup> See Article 2, paragraph 1, items 17 and 5 of the FIEA.

<sup>iii</sup> A financial holding company of a financial institution can meet this criterion, according to the TSE's responses to public comments (see footnote i) and the relevant TSE ordinance for listing rules.

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