The Development of Exchange-Traded Funds (ETFs) in Japan

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On 6 June of this year Japan's Financial Services Agency amended a number of government and cabinet ordinances to enable financial services companies to create new exchange-traded funds (ETFs) alongside the existing funds which track the Nikkei 300. Following that, on 13 July, a number of exchange-traded funds which track the Nikkei 225 and TOPIX were listed on the Tokyo Stock Exchange (TOPIX) and the Osaka Securities Exchange (Nikkei 225), and trading in them commenced.

1. Growing Interest in Exchange-Traded Funds

One of the most important elements of the emergency economic package announced by the Japanese government in April was its plan to reform the country's securities markets. One example of this was the decision to introduce exchange-traded index funds which can be invested and distributed in-kind. Subsequently, amendments were made to government and cabinet ordinances to allow such funds to be created. On 13 July, a total of five funds were listed on the Tokyo Stock Exchange and the Osaka Securities Exchange, and trading in them commenced (see Table 1).

Table 1 Recent Developments Concerning Exchange-Traded Funds in Japan

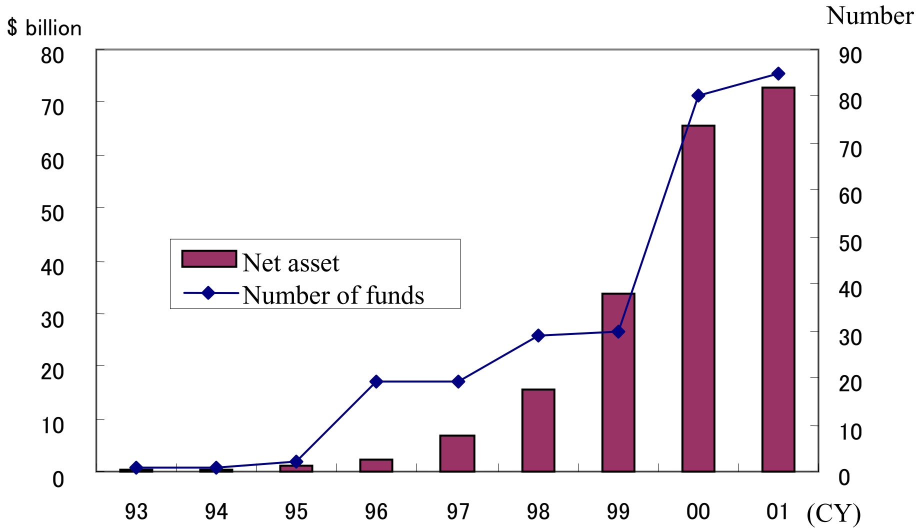
Date	Event
9 March	"Measures to encourage the development of exchange-traded funds" included in the ruling coalition's emergency economic package.
6 April	"Institutional measures to encourage exchange-traded funds" included in the government's emergency economic package. Exchange-traded funds identified as having a possible role to play in the purchase of bank shareholdings by a body set up for this purpose.
6 June	Measures (amendments to the Investment Trust Law's implementation ordinances and tax measures—such as implementation ordinances for the Income Tax Law and the Special Taxation Measures Law) adopted to facilitate exchange-traded funds.
19 June	Tokyo Stock Exchange and American Stock Exchange (AMEX) sign strategic agreement on exchange-traded funds.
9 July	Nomura Asset Management, Daiwa Asset Management and Nikko Asset Management launch exchange-traded funds that track the Nikkei 225.
11 July	Nomura Asset Management and Daiwa Asset Management launch exchange-traded funds that track TOPIX.
13 July	Trading in five new exchange-traded funds begins on the Tokyo Stock

	Exchange and the Osaka Securities Exchange.

Source: NRI.

Trading in exchange-traded funds has grown rapidly in recent years, especially in the United States and Europe. More than 80 such funds are traded on the American Stock Exchange (AMEX), a pioneer in listing exchange-traded funds, and these now account for half the exchange's volume. As of the end of May, 85 exchange-traded funds with a net asset value of $72.7 billion were traded in the United States (see figure).

Figure Number of Exchange-Traded Funds in the United States and Their Net Asset Value



Source: NRI, from Investment Company Institute data.

Exchange-traded funds track a particular stock index (hence the name "index funds") but are closed-end funds—unlike normal index funds, which are open-end and can be purchased and redeemed by investors at any time at a standard price based on the funds' net asset value. This means, as their name indicates, that they are listed on a stock exchange and traded just like equities.

Country funds, which invest in emerging market equities, are also exchange-listed mutual funds; but normally they are not allowed to issue additional units or redeem existing ones. In contrast, exchange-traded funds can issue additional units or redeem existing ones in the form of equities at any time. This is why exchange-traded funds are said to be "in-kind." It is also why it is possible to arbitrage between fund units and the underlying equities, thereby limiting any discount to or premium over a fund's net asset value. Exchange-traded funds can therefore be said to be hybrids between open-end funds and pure closed-end ones.

The reasons for the growing interest in exchange-traded funds include (1) the fact that retail investors have become increasingly interested in index funds at the expense of active funds, which do not necessarily outperform benchmarks even though they tend to have high management charges; (2) the fact that exchange-traded funds tend to have a low tracking error compared with other index funds and can easily be traded (e.g., shorted) in line with the direction of the market; and (3) the fact that stock exchanges in different countries have been taking a keen interest in such funds as a way of trying to gain an edge as competition among stock markets intensifies.

In Japan, the only exchange-traded funds are those launched and listed in May 1995 to track the Nikkei 300. Moreover, the number of listed units has declined significantly as a result of continuing redemptions—partly because the Nikkei 300 is not very well known—and volume is now also low.

However, pressure (especially from Japan's stock exchanges) has been mounting in recent years to expand the role of exchange-traded funds as a way of inducing retail investors to become more active players in the stock market at a time when pressure on Japanese banks and companies to dispose of their cross-shareholdings is also mounting. There have also been suggestions that exchange-traded funds could be used in Japan to dispose of shares purchased from the country's banks. These suggestions have been inspired by the use of tracker funds in Hong Kong to dispose of the shares purchased by the Hong Kong government (as part of its market support operation) at the time of the Asian currency crisis.

2. Arrangements for Listing and Trading Exchange-Traded Funds

When the first exchange-traded funds (Nikkei 300 tracker funds) were launched in Japan in 1995, efforts were made to ensure that the necessary institutional arrangements were in place: the Special Taxation Measures Law and related government and ministerial ordinances were passed; investors with more than a certain number of beneficiary units were able to exchange their beneficiary certificates for a portfolio of the underlying shares; and for tax purposes the funds were treated in the same way as equities.

However, these arrangements applied solely to exchange-traded funds tracking the Nikkei 300: funds tracking any other stock index were not allowed. The reason for this restriction was that, at that time, the authorities were worried about the impact of the increase in trading of Nikkei 225 futures on the cash market and saw the Nikkei 300 as an alternative. The launch of exchange-traded funds in Japan in 1995 was therefore part of the government's policy to try to establish a new stock index.

Moreover, when the Investment Trust Law was amended in May 2000, a rule was adopted which required all investment trusts (i.e., mutual funds) to be cash trusts unless they were "securities trusts and designated risk-free by government ordinance" (Investment Trust Law, Article 5.3). This made it impossible to create exchange-traded funds in Japan that held shares directly as in the United States.

In order to address this shortcoming, government and cabinet ordinances permitting new, in-kind exchange-traded funds to be created as exceptions to Article 5.3 of the Investment Trust Law were passed in June 2001. In order to qualify as exceptions, funds have to meet the following conditions (Government Ordinance on Investment Trust Law, Article 8.2):

In order to ensure that the net asset value per unit has the same volatility as the stock index expressing the overall price level of the majority of stocks, such funds shall invest in shares of the stocks constituting the index concerned.

Investors applying for such funds shall receive beneficiary certificates representing a basket of stocks where the number of shares in each stock is in the same proportion as in the stock index which the fund seeks to track.

The beneficiary certificates of such funds shall be listed on a stock exchange or OTC market and may be exchanged for the shares which they represent in accordance with the cabinet ordinances governing them.

At the same time, the following stock indices were designated in a directive from the Financial Services Agency "indices expressing the overall price level of the majority of stocks" and therefore eligible investments for in-kind exchange-traded funds: (1) the Nikkei 225, (2) TOPIX, (3) the Nikkei 300 and (4) the S&P/TOPIX 150.

In addition, measures (such as passing government ordinances to accompany the Income Tax Law and the Special Taxation Measures Law) were taken to ensure that any future exchange-traded funds would enjoy the same tax treatment as the existing funds that track the Nikkei 300 (i.e., be treated as equities).

3. Issues Outstanding

As a result of these measures, the obstacles that previously impeded the creation of new exchange-traded funds in Japan have been removed. Since then, the Tokyo Stock Exchange and the Osaka Securities Exchange have finalized their listing requirements for such funds, and five were listed on 13 July of this year (see Table 2).

In the United States there is now a large market in exchange-traded funds, and AMEX, which has played a leading role in developing such products in order to further its own development as a stock market, has created an exchange-traded fund for each of a number of the best-known US stock indices. As exchange-traded funds have become increasingly popular, it has been emulated by other stock exchanges, which have developed and listed new exchange-traded funds that track the same stock indices as its funds do or which want to trade funds that are already traded elsewhere.[1]

Table 2 New Exchange-Traded Funds in Japan

Sponsor	Nomura Asset Management		Daiwa Asset Management		Nikko Asset Management
Index tracked	TOPIX	Nikkei 225	TOPIX	Nikkei 225	Nikkei 225
Exchange where listed	TSE	OSE	TSE	OSE	TSE
Trustee	Toyo Trust		Sumitomo Trust		Toyo Trust
Participating parties	Eight companies, including Nomura Securities, Shinko Securities, Goldman Sachs Japan and UBS Warburg Japan		Daiwa Securities SMBC, Tsubasa Securities, Morgan Stanley Dean Witter Japan		Nikko Securities, Nikko Salomon Smith Barney, Merrill Lynch Japan
Round lot	100 units	10 units	100 units	10 units	10 units
Expense ratio	0.22%	0.22%	0.23%	0.23%	0.225%
Net asset value	¥29 billion	¥78 billion	¥5 billion	¥38 billion	¥61 billion

Notes: 1 Net asset values as of 16 July, 2001.
2 "Participating parties" refers to the securities companies involved in the launch of the new funds and prepared to exchange beneficiary certificates for the underlying equities.
Source: NRI.

In Japan, on the other hand, the development of exchange-traded funds has taken the form of a number of funds developed independently by different asset management companies being listed. As a result, several of these funds track the same index. As exchange-traded funds try to track an index as closely as possible, there is little scope for the fund manager to show his skills (or lack of them). The asset management companies in this case have therefore kept their funds rather small—an unfortunate development as it could prevent them from making the most of economies of scale.

[1] On 31 July the New York Stock Exchange began trading in three exchange-traded funds (linked, respectively, to the S&P 500, the NASDAQ 100 and the Dow Jones Industrial Average) that are listed on AMEX. The NYSE is able to do this by virtue of its "unlisted trading privileges," which allow it to trade in securities that are already listed on other exchanges without having to go through the process of listing all over again.

Be that as it may, the new exchange-traded funds can probably be said to have got off to a reasonable start considering that the net asset value of the first such funds to be launched in Japan (based on the Nikkei 300) was only ¥35.5 billion as of May 2001.[2] The total trading value of the new funds when they were launched on 13 July was ¥10.2 billion, but by the end of that week (19 July) it had risen to ¥16.4 billion. Ninety percent of trading value has been accounted for by retail investors, who are familiar with the Nikkei 225. This development matches a global trend towards low-cost index investment, and it is to be hoped that it will help to establish the popularity of investment trusts (mutual funds) among retail investors in Japan once and for all.

As a result of the various measures that have been taken, however, any new exchange-traded funds in Japan are limited to ones that track the four stock indices designated in the Financial Services Agency's directive. The reason for this (according to the Agency's response to public comment) is "to ensure a proper process of price formation and prevent any price manipulation. To achieve this, it was felt that only stock indices which had a significant number of constituents and were not oversensitive to the price movements of a limited number of stocks were suitable. Similarly, it was felt, for example, that stock indices traded (or due to be traded) on a futures exchange would be suitable because of investors' familiarity with them."

As for the possibility of creating exchange-traded funds that track other stock indices and were not covered by the recent measures, the Agency has said that it will consider this in future. However, regulations that amount to a system of having to seek approval in advance are hardly conducive to fostering a distinctive and competitive product development capability. Also, using the fact that a particular stock index is (or is due to be) traded on a futures exchange as a criterion for approving the creation of new exchange-traded funds would hardly seem realistic when restrictions on trading in OTC derivatives have already been lifted in order to satisfy investor demand for a wide range of futures products.

On the whole, the recent legal provisions are to be welcomed for the fact that they allow new exchange-traded funds to be created. Likewise, while the fact that they limit such products to funds that track the four designated stock indices is less than ideal, it is understandable that the authorities could only permit the launch of new exchange-traded funds one step at a time inasmuch as the Investment Trust Law forbids cash trusts unless they are "designated risk-free by government ordinance."

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2 Partly because the exchange-traded funds that track the Nikkei 300 were launched for policy reasons (i.e., to familiarize investors with this index), the initial net asset value of these funds was ¥34.98 billion. Since then, however, these funds have shrunk as a result of redemptions (investors exchanging their beneficiary certificates for the underlying equities) and are now only one seventh their original size in terms of the number of beneficiary units listed.

Finally, in its response to public comment on its draft ordinance, the Financial Services Agency made it clear that any exchange-traded funds launched overseas that track a stock index other than the four designated ones would not be considered to be "foreign investment trusts" as defined in the Investment Trust Law. What this means is that the Standard & Poor's depositary receipts (SPDRs or "Spiders") that track the S&P 500 and the exchange-traded funds that track the NASDAQ 100 (both listed on AMEX), for example, would probably be treated in Japan as foreign stocks rather than foreign investment trusts.