Guide to UCITS ETFs in Ireland

DILLON EUSTACE

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Introduction

There has been dramatic growth in recent years both in terms of the size of the ETF market and the number of products available in the market. As of November, 2018 assets in Global ETFs amounted to US$4.93 trillion with the biggest market being in the United States with assets in US ETFs amounting to US$3.51 trillion[1]. In Europe, there has also been year on year growth with assets in European ETFs amounting to US$754[2] billion as of November 2018 in relation to which Ireland is home to approximately 54% of such ETF assets[3] significantly more than its nearest rival domicile making Ireland the leading European domicile for these types of funds.

This brochure gives an introduction to ETFs and how they have evolved over time, with further details on how ETFs operate in the primary and secondary markets, UCITS regulatory requirements, listing on Euronext Dublin (formerly the Irish Stock Exchange) and the ability to passport to be admitted to trading on the London Stock Exchange and finally some tax information as applicable to Irish domiciled ETFs.

You are likely to be interested in this guide if you are:

- new to the ETF industry and seeking information on ETFs and what distinguishes an ETF from an open-ended investment fund;
- an existing asset manager considering the setting up of a UCITS ETF;
- participating on a ETF platform and considering the setting up of a stand-alone UCITS ETF; or
- a non-EU ETF service provider considering the setting up of a UCITS ETF.

If you have any questions, please contact us.

Dillon Eustace
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[1] ETFGI website
[2] ETFGI website
[3] Irish Funds

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Guide to UCITS ETFs in Ireland

1. Introduction to ETFs

An exchange traded fund ("**ETF**") is a form of collective investment scheme which is structured to facilitate the trading of its shares on an exchange throughout the day using real time pricing in a similar manner to the way in which an equity security may be traded on an exchange. This feature distinguishes it from traditional collective investment schemes which only provide for direct subscriptions and redemptions of their shares on a periodic basis using the net asset value share.

Although it is possible to establish and list non-UCITS ETFs on certain exchanges (such as the London Stock Exchange), European ETFs are primarily established as undertakings for collective investment in transferable securities ("**UCITS**") which benefit from the strong global UCITS brand and the efficient passport regime which allows UCITS to be sold on a retail basis throughout the EU. As a result, this brochure focuses only on UCITS ETFs.

Historically, ETFs have been structured as passively managed funds tracking an index weighted by market capital (*passive ETFs*). Such passive ETFs seek to provide their investors with a return closely aligned to the return of the relevant index which they track. This may be done through physically holding a portfolio of securities in the same weighting as that held by the relevant index. This would commonly be referred to as a *physical ETF*. Alternatively, an ETF may seek to track an index through the use of derivatives (*synthetic ETFs*) or a mix of derivatives and securities or through the use of a sampling strategy where the ETF acquires a subset of the underlying index's securities and invests a portion of the ETF's portfolio in other securities and/or derivatives that are not included in the corresponding index on the basis that such investments will assist the ETF track the underlying index.

The breadth of ETF products available to investors has expanded considerably as the market has grown. Some ETFs now track more specialised indices, including fixed-income indices, commodity indices, alternative indices or indices focused on particular industry sectors or themes. Some ETFs seek to track highly customized or bespoke indices, while others seek to provide a level of leveraged or inverse exposure to an index over a fixed period of time. Investors also have the ability to invest in ETFs that do not track a particular index and are actively managed. Actively managed ETFs are ETFs where the manager has discretion over the composition of its portfolio subject to the stated objectives and policies as opposed to a passive ETF which tracks an index. We also have seen the introduction of "Smart Beta" or "Factor" ETFs. Although Smart Beta ETFs track an index like other passive ETFs, they do so in ways besides the traditional market capital weighted approach e.g. an index weighted by one or more factors such as dividend yield, small and mid-cap companies, volatility, etc.

Although there have been a number of actively managed ETFs established in Europe, it remains to be seen whether we will see growth in actively managed ETFs (in particular actively managed equity funds) given concerns around, inter alia, transparency requirements which apply to ETFs i.e. disclosure of the composition of the ETF portfolio on a daily basis to enable inter alia the Authorised Participant(s) and other market makers to value the ETF portfolio on an intra day basis which in turn enables them to take steps to ensure the market price does not vary significantly from the net asset value per share of the ETF and to hedge its intraday risk. Such transparency is not a concern, at least to the same extent, for non-equity active managers. In addition, the Central Bank of Ireland (the "**Central Bank**") has stated that it would continue to engage in European and international regulatory forums on the issue in the future.

Furthermore, it is now possible for Irish domiciled UCITS to have a combination of non-listed classes and exchange traded listed classes. Therefore it is open to active managers to introduce exchange traded listed classes to their existing managed UCITS comprising non-listed classes.

2. How an ETF Operates

2.1 Primary Market

One or more market makers (referred to as "**Authorised Participants**") are appointed by an ETF to subscribe for and redeem ETF shares directly from the ETF but usually only in large blocks called creation units.

Typically, subscriptions and redemptions in the ETF will be for one or multiple "creation units" comprising a designated number of shares (50,000 for example). These shares will then typically be sold by the Authorised Participant(s) on the secondary market.

Payment for a creation unit may be provided in cash[4] or in-kind by the delivery of a basket of securities and other assets (i.e. cash) (the "**Creation Basket**" in the event of a subscription for ETF shares or the "**Redemption Basket**" in the event of a redemption of ETF shares) which, (i) in the case of a passive ETF that is physically replicated, closely replicates the composition and weighting of the securities held within the relevant index or (ii) in the case of an actively managed ETF, is representative of the ETF's portfolio and is equal in value to the net asset value of the ETF shares in the creation unit.

Primary market redemptions may be effected by the Authorised Participant(s) requesting the redemption of ETF shares directly from the ETF. Such redemption requests must

[4] Payment for a creation unit is provided in cash in the case of a synthetic ETF and usually provided in kind in the case of a physical ETF in order to keep the ETF's transaction costs low. The latter also presents opportunities to generate income by the ETF entering into securities lending transactions

correspond in size with one or more creation units. Once the redemption request is processed, the relevant ETF shares are cancelled and the Authorised Participant(s) will receive cash or, where redemptions in kind are processed, securities and other assets representative of the relevant index/portfolio comprised in the Redemption Basket for each creation unit redeemed.

Cash creations and redemptions are generally required for ETFs where there are concerns regarding the liquidity and trading costs of underlying securities which may result in higher bid offer spreads offered by the Authorised Participant(s). Cash settlement is also required for Synthetic ETFs.

2.2 Secondary Market

The ETF shares will be listed / traded on an exchange (such as the London Stock Exchange or Deutsche Boerse, etc.,) where they can be freely purchased and sold, with the settlement of trades in ETF shares on an exchange being facilitated through one or more recognised settlement systems, for example, CREST, Clearstream or Euroclear.

As a result, investors can buy and sell ETF shares in large or small amounts through the exchange on a real time, intra-day basis without attracting subscription or redemption charges.

The price of ETF shares traded on the secondary market will be determined by the level of supply and demand in the market but should through arbitrage opportunities correspond approximately to the net asset value per share of the ETF based on the value of its underlying assets. Generally an indicative net asset value ("**INAV**" i.e. estimate of the value of an ETF share based on the relevant day's holdings as disclosed in the relevant ETF's Creation Basket) is issued by or on behalf of the ETF at regular periods intra-day. This enables investors in the secondary market to determine whether the market price of the ETF shares is a fair reflection of the price of the ETF's holdings. However not all ETFs publish an INAV as requirements for an INAV are generally driven by the stock exchange on which the ETF is listed or traded.

Because ETF shares are exchange-traded, secondary market investors in ETF shares are subject to trading costs, such as bid-offer spreads. The market makers acting as liquidity providers to an ETF (the "**Liquidity Providers**") create a market in the ETF by providing bid and offer prices and facilitating the trading of shares on the secondary market. The bid-offer spread can change throughout the day due to inter alia the supply of or demand for ETF shares, the quantity of shares traded, and the time of day the trade is executed. The spreads can also narrow and widen to reflect the intra-day risk of the Liquidity Providers.

In the event that the market price of a UCITS ETF's shares on an exchange significantly vary from its net asset value, the ETF is required to make sure that appropriate processes are in place in order to allow investors who have acquired their ETF shares on the secondary market to sell them directly back to the UCITS ETF[5]. Accordingly, procedures in these circumstances need to be put in place and agreed with the ETF, its service providers and Authorised Participant(s).

2.3 Pricing and arbitrage

The combination of the creation and redemption process in the primary market with secondary market trading in ETF shares provides arbitrage opportunities that are designed to help keep the market price of ETF shares at or close to the net asset value per share of an ETF. For example, if the shares of an ETF that deals in specie begins to trade on the secondary market at a discount to the net asset value per share of the ETF at any time during the trading day, the Authorised Participant(s) can purchase ETF shares in the secondary market and after accumulating enough ETF shares to comprise a creation unit, redeem them from the ETF in exchange for the more valuable securities in the ETF's Redemption Basket. The Authorised Participant's purchase of the ETF's shares on the secondary market, combined with the sale of the ETF's assets in the Redemption Basket may create upward pressure on the price of the ETF shares, downward pressure on the price of the assets in the Redemption Basket, or both, bringing the market price of the ETF shares and the value of the ETF's portfolio holdings closer together. As part of this arbitrage process, Authorised Participants are likely to hedge their intraday risk. So in the above example, when ETF shares are trading at a discount to the estimated intraday net asset value per share of the ETF, an Authorised Participant may short the securities comprising the ETF's Redemption Basket. After the Authorised Participant transfers a creation unit of ETF shares to the ETF in exchange for the ETF's Redemption Basket, the Authorised Participant can then use the assets in the Redemption Basket to cover its short positions.

Similarly, if the shares of an ETF begin to trade on the secondary market at a premium to the net asset value per share of the ETF, the Authorised Participant(s) may profit by shorting ETF shares in the secondary market, purchasing the underlying securities that make up a Creation Basket and subscribing in kind for ETF shares on the primary market in creation unit size denominations and delivering the ETF shares on the secondary market to settle the short position.

This arbitrage activity can operate as a market force ensuring that the ETF market prices do not vary to a significant extent from the prices of the underlying securities where the disparities in price present an opportunity to the Authorised Participant(s) to earn an arbitrage profit.

[5] ESMA source. ESMA Guidelines on ETF and Other UCITS (ESMA/2014/937 EN)

Liquidity Providers may also engage in arbitrage activities that do not necessarily require them to engage in creations or redemptions with the ETF. For example, if a Liquidity Provider believes that an ETF is overvalued relative to the ETF's underlying portfolio, the Liquidity Provider may sell ETF shares, buy the underlying assets of the ETF and if the trading prices move toward parity, close out the positions in both the ETF shares and the underlying assets of the ETF. The Liquidity Provider would therefore realise a profit from the relevant movement of these trading prices without engaging with the ETF for the creation of units. Similarly a Liquidity Provider could buy ETF shares in the secondary market and sell the underlying assets of an ETF in an attempt to profit when an ETF's shares are trading in the secondary market at a discount to the underlying assets of the ETF.

3. UCITS ETFs

As detailed above, ETFs in Ireland are primarily established under the UCITS regime which benefit from the principle of mutual recognition within the EEA and can be marketed in other EEA member states under the UCITS "passport" once authorised in one EEA member state. In fact, Irish domiciled funds are sold in 70 countries across Europe, the Americas, Asia and the Pacific, the Middle East and Africa[6].

While a UCITS may be established in Ireland in a number of legal forms, the listing on an exchange has historically generally resulted in an ETF being constituted in Ireland as a corporate vehicle.

3.1 General UCITS Requirements

Importantly, an ETF set up under the UCITS regulations will have to comply with UCITS rules relating to eligibility of assets, use of derivatives (e.g. global exposure/leverage, counterparty exposure, cover requirements, underlying position exposure), general concentration limits, replication of an index etc. (depending on whether the ETF is a passive ETF or actively managed ETF).

Under what is commonly known as the 5/10/40 rule, it is a general requirement that a UCITS may invest no more than 10% of its net assets in transferable securities or money market instruments issued by the same body, provided that the total value of transferable securities or money market instruments held in issuing bodies in each of which it can invest more than 5% is less than 40%.

However, as outlined below, there are more flexible rules for index tracking funds.

[6] Irish Funds

- 20% and 35% Rule

A UCITS whose policy is to replicate an index may invest up to 20% of net assets in shares and/or debt securities issued by the same body, with the 20% limit being raised up to 35% in the case of a single issuer where justified by exceptional market conditions. This flexibility is permitted where the relevant index is sufficiently diversified, represents an adequate benchmark for the market to which it refers and is published in an appropriate manner.

- Index replication

The reference to "replication" of the composition of a shares or debt securities index is considered by the Central Bank to mean replication of the composition of the underlying assets of the index including the use of derivatives or other permitted UCITS efficient portfolio management techniques and instruments.

- Sufficient diversification

Although somewhat circular, reference to an index's composition being diversified refers to an index which allows for a maximum weighting per issuer of 20% with a capacity for a single constituent to exceed 20% but not exceed 35% of the index.

- Adequate benchmark

The reference to the index representing an adequate benchmark for the market to which it refers is a reference to an index whose provider uses a recognised methodology which generally does not result in the exclusion of a major issuer of the market to which it refers.

- Publication

The requirement that the index be published in an appropriate manner is taken as a reference to an index which is accessible to the public and where the index provider is independent from the index replicating UCITS. Note, however, that this second requirement does not preclude index providers and the UCITS forming part of the same economic group provided that effective arrangements for the management of conflicts of interest are in place.

- Eligibility of assets comprising the index

If an ETF wishes to track an index by directly holding components of the index (rather than employing derivatives to gain synthetic exposure to the components of the index), then, as a UCITS, such an ETF could only target indices comprising eligible assets for UCITS investment. This would exclude, for example, commodities indices. An Irish UCITS fund may, subject to compliance with certain requirements of the Central Bank, gain exposure – only via derivatives - to a financial index comprised of non-eligible assets.

3.2 Disclosure Requirements

3.2.1 Index Tracking Funds

In accordance with European Securities and Markets Authority's ("**ESMA**") Guidelines on ETFs and other UCITS issues, a UCITS which replicates a stock or debt securities index is required to include a prominent statement to this effect in the prospectus and any other promotional literature. Further, the prospectus of an index-tracking UCITS is required to include:

(a) a clear description of the index including information on the underlying components or details of the website where the exact composition of the index is published;

(b) information on how the index will be tracked (for example, whether it will follow a full or sample based physical replication model or a synthetic replication model) and the implications of the chosen method for shareholders in terms of their exposure to the underlying index and counterparty risk (this information should also be included in summary form in the Key Investor Information Document);

(c) information on the anticipated level of tracking error in normal market conditions;

(d) a description of factors that are likely to affect the ability of the UCITS to track the performance of the index, such as transaction costs, small illiquid components or dividend re-investments.

In the case of an index-tracking leveraged UCITS (i.e. a UCITS, the strategy of which is to have a leveraged exposure to an index or exposure to a leveraged index), the prospectus must include the following information:

(a) a description of the leverage policy, how this is achieved (i.e. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage (where relevant) and the risks associated with this policy;

(b) a description of the impact of any reverse leverage (i.e. short exposure);

(c) a description of how the performance of the UCITS may differ significantly from the multiple of the index performance over the medium to the long term.

The above information must also be disclosed in summary form in the Key Investor Information Document of the UCITS.

The annual and half-yearly reports of an index-tracking UCITS must disclose the size of the tracking error at the end of the period under review. The annual report must provide an explanation of any divergence between the anticipated and realised tracking error for the relevant period and must also disclose and explain the annual tracking difference between the performance of the UCITS and the performance of the index tracked.

3.2.2 Actively Managed ETFs

The prospectus of any actively-managed UCITS ETF must make clear that the fund does not track an index and is actively managed by the fund's manager. Information must also be provided on how the fund's manager intends to meet its investment policy, including where applicable its intention to outperform an index.

3.2.3 All ETFs

In order to make investors aware of the distinction between exchange traded UCITS and traditional open-ended UCITS, a UCITS ETF is required to use the identifier 'UCITS ETF' which identifies it as an exchange-traded fund. If all the sub-funds are UCITS ETFs, the labelling requirement applies at the sub-fund level and the UCITS may decide to apply it to the umbrella level as well. However, if not all the sub-funds are UCITS ETFs, the labelling requirement only applies to the relevant sub-funds.

4. ETF Listing

One of the main objectives in launching an ETF is access to capital markets. This is normally achieved by having the ETF listed or traded on at least one actively traded exchange. The more popular European exchanges include the London Stock Exchange ("**LSE**") and the Deutsche Boerse.

ETF's which list on Euronext Dublin (formerly the Irish Stock Exchange) can avail of a "passport" to be admitted to trading on the LSE. This is a very efficient way for an ETF to access the LSE. It provides significant cost and time savings when compared to an ETF making a direct application for listing on the LSE. This procedure has been successfully used by a number of ETF providers to access trading on the LSE.

For further detail on the listing procedures for Irish ETFs on Euronext Dublin, please see our listing brochure: https://www.dilloneustace.com/uploads/files/Guide-to-listing-Investment-Funds-on-Euronext-Dublin.PDF

5. ETF Tax

5.1 Direct Tax

An Irish ETF will not be subject to Irish taxation on any income or gains it may realise from its investments. In addition, there should be no Irish withholding taxes in respect of a distribution of payments in respect of shares or any encashment, redemption, cancellation or transfer of shares by the ETF.

5.2 Indirect Tax

No stamp duty is payable in Ireland on the issue, transfer, repurchase or redemption of shares in an ETF. Furthermore, no stamp duty is payable by an ETF on the conveyance or transfer of stock or marketable securities in which it invests provided that the stock or marketable securities in question have not been issued by a company registered in Ireland and provided that the conveyance or transfer does not relate to any immovable real estate situated in Ireland or any right over or interest in such real estate or to any stocks or marketable securities of a company (other than a company which is a fund or securitisation vehicle) which is registered in Ireland.

There are wide ranging VAT exemptions with regard to the provision of services to ETFs (e.g. administration, transfer agency, investment management, custodial, etc.) and to the extent that the ETF suffers Irish VAT on certain services it receives (e.g. audit and legal fees), the ETF may recover this VAT based on its recovery rate. Certain services received from abroad (e.g. the service of non-Irish lawyers or accountants) will require an ETF to register and self-account for VAT in Ireland. However, depending on the ETF's VAT recovery rate, the ETF may be able to recover some or all of this Irish VAT. Once registered for Irish VAT, the normal VAT filing and record keeping obligations under Irish VAT law will apply.

5.3 Treaty Access

Ireland has an extensive and expanding tax treaty network now numbering over 70 countries. The availability of treaty benefits for ETFs in any particular case will ultimately depend on the relevant tax treaty and the approach of the tax authorities in the treaty country and therefore treaty access needs to be reviewed on a case-by-case basis. Nevertheless, under the US / Ireland double tax treaty, funds that are residents of Ireland for treaty purposes (e.g. ETFs) and whose principal classes of shares are listed and traded on any recognised stock exchange are generally considered qualified persons entitled to treaty benefits. Consequently, a significant advantage for Irish-domiciled ETFs is their access to the US / Ireland double tax treaty where the ETF is demonstrated to be trading.

6. How can Dillon Eustace assist you?

Dillon Eustace has one of the largest Financial Services legal practices in Ireland serving clients across a whole range of activities, including Asset Management and Investment Funds, Investment Services, Insurance and Pensions, Debt and Funds Listing, Regulatory and Compliance and Regulatory Investigations.

We represent the largest number of Irish domiciled funds (Monterey Insight – Ireland Fund Survey 2018) reflecting the fact that the Asset Management and Investment Funds practice has been, and remains, one of the firm's core activities with partners having been to the forefront of the Irish funds industry from its beginning.

Dillon Eustace has a specific ETF Group within its Financial Services Department comprising legal and listing expertise that focuses on ETF matters and can advise you on all aspects of the UCITS ETF establishment and listing process.

We have been involved in establishing numerous Irish domiciled ETFs (both passive and active ETFs) to date, most of which have been listed on numerous European exchanges such as London Stock Exchange, Deutsche Boerse, Borsa Italiana and Euronext. Dillon Eustace has also been involved in establishing the first ETF listed in the Persian Gulf.

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact us.

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