November 2014

Exchange Traded Funds and the UCITS Framework

Introduction

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 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.

European ETFs are 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. Although non-UCITS EU funds (“**AIFs**”) may also avail of an EU passport regime under the AIFM Directive where such AIFs are marketed to professional investors, the establishment of such AIFs as ETFs is not currently practical given operational issues involved in ensuring investors are limited to professional investors. EU AIFs marketed to retail investors cannot avail of the EU passport under the AIFM Directive but it is hoped that this may change in the future.
To date, ETFs have generally been structured as passively managed index tracking funds (*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 (such as a total return swap) or a mix

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of derivatives and securities. This structure is sometimes referred to as a *synthetic ETF*. The use of derivatives will give rise to leverage and counterparty exposure and therefore such derivatives will be required to be managed and monitored in accordance with the UCITS requirements. Please refer to our UCITS brochures for details on the regulatory requirements which apply to Irish UCITS funds.
http://www.dilloneustace.ie/download/1/A%20Guide%20to%20UCITS%20in%20Ireland.pdf

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. It is estimated that as of April 2014, there was approximately Euro 444 billion invested in European ETFs and that Irish domiciled ETFs accounted for 43% of these ETFs[1] (making Ireland the leading European domicile for these types of funds). The breadth of ETF products available to investors has expanded considerably as the market has grown. ETFs are now based upon a wide range of equity and fixed income indices which cover a broad range of industry sectors. We also have seen the introduction of Smart Beta ETFs which although they track a passive index like other passive ETFs, they do so in ways besides the traditional market cap weighted approach. We are also now beginning to see the emergence of actively managed ETFs (i.e. a UCITS ETF 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). However, it remains to be seen whether we will see growth in actively managed ETFs given concerns around transparency requirements which apply to ETFs, i.e. disclosure of the composition of the ETF portfolio on a daily basis to enable the Authorised Participant to value the ETF portfolio on an intra basis which in turn enables it to take steps to ensure the market price does not vary significantly from the net asset value per share price of the ETF and to hedge its intraday risk.

Trading in an ETF

Primary market

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

Payment for a creation unit (comprising a designated number of shares) may be provided in cash[2] or in-kind by the delivery of a basket of securities and other assets (i.e. cash) 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.

[1] Source: IFIA April 2014.

[2] 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.

Primary market redemptions may be effected by the Authorised Participant requesting the redemption of its ETF shares directly from the ETF. Such redemption requests must 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 will receive cash or, where redemptions in kind are processed, securities and other assets representative of the relevant index/portfolio..

Secondary market

The ETF shares will be listed on an exchange (such as the London Stock Exchange) 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 market but should 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**") is issued by or on behalf of the ETF at regular periods intra-day. The relevant exchange in which the ETF shares are listed generally obliges Authorised Participants to quote bid/offer spreads on the secondary market within a few basis points of the most recent indicative net asset value. The bid/offer spreads allow the Authorised Participant to cover the risk of buying/redeeming shares in the primary market (in order to settle trades in the secondary market) at a price different to the price which the shares are sold/bought on the secondary market. The Authorised Participant creates a market by subscribing/redeeming in the primary market in order to settle trades which it has made with investors on the secondary market.

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[3]. Accordingly, procedures in these circumstances need to be put in place and agreed with the ETF, its service providers and Authorised Participant(s).

Establishing an ETF as a UCITS fund

As stated above, ETF's in Ireland are currently established under the UCITS regime which benefit from the principle of mutual recognition within the EU and can be marketed in other EU member states under the UCITS "passport" once authorised in one EU member state.

While a UCITS may be established as a unit trust or common contractual fund, the listing on an exchange has historically generally resulted in an ETF being constituted in Ireland as a variable

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

capital company (VCC) with limited liability. An alternative corporate structure (the Irish Collective Asset - management Vehicle ("**ICAV**")) is expected to be available to ETF promoters commencing 2015 with the enactment in Ireland of the Irish Collective Asset – management Vehicles Bill 2014.[4]

UCITS Funds

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 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.

(i) 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 recognised by the Central Bank of Ireland (the "**Central Bank**") on the basis that it is sufficiently diversified, it represents an adequate benchmark for the market to which it refers and it is published in an appropriate manner.

(ii) 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.

(iii) 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.

[4] For further information on the ICAV, please refer to the following Dillon Eustace briefing at http://www.dilloneustace.ie/download/1/Publications/Financial%20Services/ICAV%20Update.PDF.

(iv) 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.

(v) 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.

(vi) 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.

Disclosure Requirements – 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.

Disclosure Requirements – Actively Managed ETF

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.

Disclosure Requirements – 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.

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 Bourse.

ETF's which list on the Irish Stock Exchange ("**ISE**") 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 future detail on the listing procedures for Irish ETFs on the ISE and LSE, please see our listing brochure:
http://www.dilloneustace.ie/download/1/Investment%20Funds%20Listing%20on%20the%20ISE%20(English).pdf

ETF Tax

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.

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.

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.

Date: November 2014

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