



Guide to
UCITS ETFs
in Ireland

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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 September, 2016, assets in Global ETFs amounted to US\$3.24 trillion with the biggest market being in the United States with assets in US ETFs amounting to US\$2.42 trillion¹. In Europe, there has also been year on year growth with assets in European ETFs amounting to US\$536² billion as of September 2016 in relation to which Ireland is home to 54% of such ETF assets³ 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 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, June 2016

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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.

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 it is possible to establish and list non-UCITS ETFs on certain exchanges (such as the London Stock Exchange), this brochure focuses on UCITS ETFs as historically only UCITS ETFs have been established and listed in Europe.

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 (*Hybrid ETFs*).

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 asset classes i.e. equities, fixed income commodities, currencies and alternatives. We also have seen the introduction of Smart Beta ETFs and actively managed 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. 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. 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 the Authorised Participant(s) and other market makers to value the ETF portfolio on an intra 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 price of the ETF and to hedge its intraday risk.

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 (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.

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 cash⁴ or in-kind by the delivery of a basket of securities and other assets (i.e. cash) (the “**Creation Basket**”) 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 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 Creation 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

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

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**” 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. The bid/offer spreads offered by the Authorised Participant(s) allows it 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(s) create a market by providing bid and offer prices and facilitating the trading of shares 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 ETF⁵. 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

As both the underlying securities and the ETF publish closing prices and the ETF’s portfolio holdings are disclosed, Authorised Participant(s) and other market makers can take advantage of the disparities between the net asset value per share of an ETF on the one hand and the price of ETF shares on the secondary market on the other hand. For example, if the shares of an ETF that deals in specie begin to trade on the secondary market at a discount to the value of the underlying portfolio of the ETF at any time during the trading day, the Authorised Participant(s) and other market makers can capture the difference by (a) purchasing ETF shares on the secondary market while simultaneously selling short the securities in the Creation Basket and redeeming creation unit(s) with the ETF at the end of the day at the net asset value per share and using the underlying securities in the Creation Basket to close out the short positions. Similarly, if the shares of the ETF begin to trade on the secondary market at a premium to the value of the underlying

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

portfolio of the ETF, the Authorised Participant(s) and other market makers 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 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.

Market makers 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 market maker believes that an ETF is overvalued relative to the ETF's underlying portfolio, the market maker 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 market makers 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 market maker 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.

However, an Authorised Participant's / market maker's ability to take advantage of disparities in price may be limited by the liquidity and trading costs of the underlying assets of the ETF which in addition may result in wider bid-offer spreads.

3. UCITS ETFs

As detailed above, ETFs 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 capital company (VCC) with limited liability. An alternative corporate structure (the Irish Collective Asset - management Vehicle ("ICAV")) is now also available to ETF promoters as a result of the enactment in Ireland of the Irish Collective Asset – management Vehicles Act 2015.

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).

Please refer to our UCITS brochure for more comprehensive details on the regulatory requirements which apply to Irish UCITS funds: [A Guide to UCITS in Ireland](#) which can be found under Publications at www.dilloneustace.ie.

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.

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.

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 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 further detail on the listing procedures for Irish ETFs on the ISE and LSE, please see our listing brochure: [*Guide to listing Investment Funds on the Irish Stock Exchange*](#).

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.

Earlier this year, the United States published an update of the US Model Tax Treaty. In this context, discussions have begun with the United States Treasury on updating certain elements of the Ireland / USA Double Tax Treaty.

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 2015) 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 a number of Irish domiciled ETFs (both passive and active ETFs) to date, most of which have been listed on numerous European exchanges such as Irish Stock Exchange, 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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