

Establishing a European ETF in Ireland

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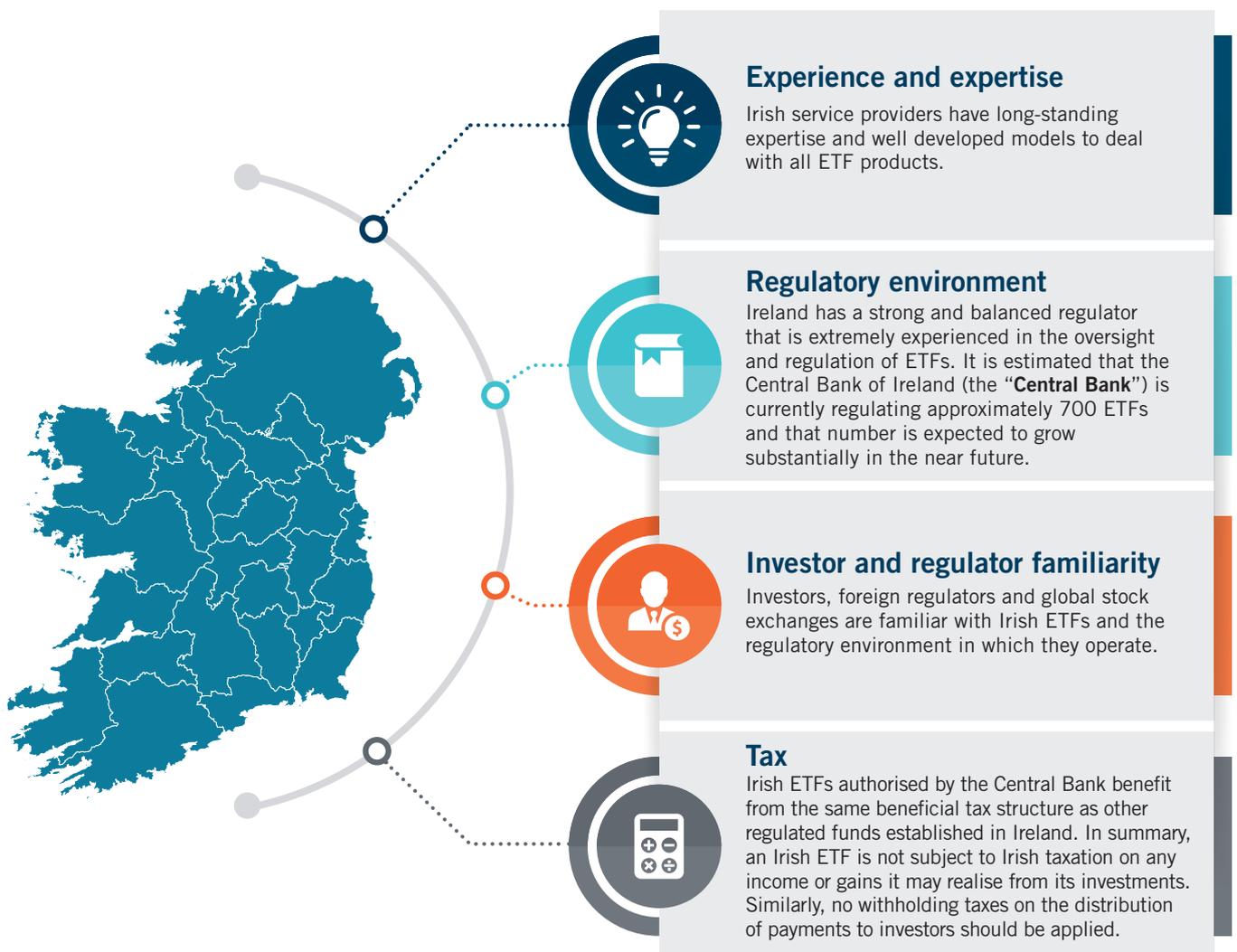


Introduction

An exchange traded fund (**ETF**) is an investment fund that is structured to allow intra-day trading of its shares on a stock exchange using real time pricing in the same manner as any other ordinary stock or share that may be traded. This differs from traditional investment funds which may only provide for direct subscriptions and redemptions of their shares on a periodic basis using the net asset value per share. European ETFs are typically established as undertakings for collective investment in transferable securities (**UCITS**) pursuant to the UCITS Directive. UCITS are investment funds established and authorised under a harmonised EU legal framework under which a UCITS established and authorised in one EU Member State can be sold cross border into other EU Member States without the requirement for any additional authorisation. This is commonly known as the “UCITS passport” and it enables fund promoters to create a single product for the entire EU rather than having to establish an investment fund product on a jurisdiction by jurisdiction basis. The ability to passport is particularly important for ETFs in order to facilitate the listing of shares on various stock exchanges. UCITS were originally introduced over 25 years ago and are now globally recognised as a highly regulated investment fund product with many non-EU jurisdictions also accepting UCITS as suitable for retail sale in their domestic markets.

Within a UCITS ETF it is possible to establish the full array of ETF products including passive ETFs (both physical and synthetic), active ETFs and smart beta ETFs.

Ireland is the leading domicile for European ETFs for a range of reasons including:



Three Key Components in Establishing a European ETF

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UCITS Fund

+

2

Specific ETF Operational and Regulatory Requirements

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3

Individual Stock Exchange Listing Requirements

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European ETF

There are three key legal components in establishing a European ETF. These components are: (1) creating a UCITS investment fund; (2) building in specific ETF operational and regulatory compliance within the

UCITS; and (3) listing the shares of the ETF on a stock exchange and complying with the individual requirements of each relevant stock exchange.



As outlined above, UCITS are a highly regulated investment fund products. The UCITS Directive and accompanying legislation and Central Bank requirements/guidance impose various obligations and restrictions on each UCITS. UCITS are restricted on the types of assets they may invest in and must comply with strict portfolio concentration and borrowing rules. By way of example, the UCITS Directive imposes various rules regarding maximum exposure to any one issuer in order to ensure the UCITS portfolio is appropriately diversified. One such rule, commonly known as the “5/10/40 rule”, essentially means that no more than 10% of the UCITS net assets may be invested in securities of a single issuer and that the total value of securities and issuers of which a fund has invested more than 5% of its net assets must not exceed, in aggregate, 40% of its net assets.

Similarly UCITS are required to operate in accordance with policies and procedures relating to matters such as risk management, liquidity management and conflicts of interest.

Aside from compliance with the UCITS product requirements (on which there is no flexibility) there are some essential elements in the establishment of a UCITS that require consideration. These include:

- **Choice of vehicle**

UCITS can be established as a range of vehicles in Ireland including investment companies, unit trusts, common contractual funds and Irish collective asset-management vehicles (**ICAVs**). Traditionally, UCITS ETFs have been established as investment companies as this facilitated the most straightforward route to listing on a stock exchange. However, since the introduction of the ICAV in 2015 this is now the most likely choice of vehicle. The ICAV is a dedicated corporate vehicle which is specifically designed to be investment fund.

- **Standalone or Umbrella UCITS**

Irrespective of the choice of vehicle, UCITS ETFs can be established as single standalone funds or as umbrella funds. Within both options, different share classes can be created with typical differentiating features including the target market (retail or institutional), minimum subscription or holding requirements, differing fees or designated currency. UCITS ETFs have traditionally been established as umbrella structures. An umbrella structure allows the creation of multiple different strategies in separate sub-funds within the same UCITS vehicle. From a timing and cost efficiency perspective it is the usually the most flexible structure. For example, an umbrella UCITS ETF may have several passive ETF sub-funds with each following different strategies together with separate active ETF sub-funds and/or smart beta ETFs.

- **Managed or Self-Managed Structure**

UCITS ETFs established as ICAVs have the option as to whether or not appoint a management company. If the UCITS ETF does not appoint a management company it is classified as a “self-managed” structure whereby the board of directors acts as the management company and delegates all day to day activity. Where a management company is appointed, it will have overall responsibility for the management of the UCITS ETF. Whether structured as self-managed or a managed fund, there will typically be delegation of day-to-day functions to third parties including an investment manager, administrator and distributor (see further details below).

It will also be necessary to comply with the minimum capital requirements. A UCITS management company must have a minimum level of financial resources equivalent to one quarter of its preceding year’s total expenditure or €125,000

for an additional amount, whichever is greater. The additional amount of capital must be equal to 0.02% of the amount by which the net asset value of the funds of the management exceeds €250 million. The required total of capital should not however exceed €10 million.

In respect of a self-managed UCITS ETF, it must comply with the minimum capital requirement of €300,000. However, this initial capital may be removed from the UCITS once it has received subscriptions from investors of at least €300,000.

- **Selection of service providers, directors and designated persons**

A Central Bank approved depositary will need to be appointed to safe-keep the assets of the UCITS ETF. It is also typical for a Central Bank approved administrator to be appointed with responsibility for the calculation of the NAV, maintenance of books and records of the UCITS ETF and maintenance of the shareholder register. Note that where a UCITS management company has been appointed to the structure, it is possible for that management company to undertake the administration activities, where authorised to do so.

The directors of the UCITS ETF will need to be approved by the Central Bank. Each director is required to demonstrate that they are fit and proper for the role pursuant to the relevant Central Bank standards and in particular that they have sufficient time capacity in order to undertake the role.

Similarly, the Central Bank imposes requirements with respect to the oversight of the UCITS ETF which may be performed by the directors themselves or by “designated persons”. The oversight responsibility is split into six different “management functions” together with a separate “organisational effectiveness” role (which may only be performed by an independent director).

The “designated persons” must also be approved by the Central Bank and must demonstrate they have the expertise to perform the oversight management function they are intended to perform.

- **Investment manager approval**

Any entity seeking to act as discretionary investment manager for an Irish authorised fund must receive prior clearance from the Central Bank to do so. In the case of EU regulated entities, this is a simple process whereby evidence of the regulatory status of the entity is provided to the Central Bank. For non-EU applicants, the entity must file an application with the Central Bank demonstrating its regulatory status and background details. For certain jurisdiction, including the US (and where the investment managers is SEC authorised) the approval process is typically straightforward.

- **Core Documentation**

The core documentation required in the launch of a UCITS includes:

- prospectus;
- constitutional document;
- sub-fund supplements;
- KIID;
- depositary agreement;
- service provider contracts;
- business plan; and
- risk management process (FDI).

The prospectus, sub-fund supplements, depositary agreement, business plan and risk management process all require pre-clearance by the Central Bank and must be submitted for review and approval. Other documentation may be filed on the day of authorisation of the UCITS ETF and must comply with set Central Bank criteria.

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Specific ETF Operational and Regulatory Requirements



In addition to the standard establishment of the UCITS as outlined above, it is necessary to set up the operational elements of the ETF and to comply with the specific ETF regulatory requirements. This is the second key component in the establishment of a UCITS ETF.

Authorised Participants

Separate to the individual operational requirements of each stock exchange upon which it is intended to list the shares of the UCITS ETF to trade (as outlined further in the third component below), the main other operational requirement that is necessary to establish a UCITS ETF is the appointment of “authorised participants”. The authorised participants play a central role in the operation of an ETF. They are appointed by the UCITS ETF and are the only entities authorised to directly subscribe and redeem shares to/from the UCITS ETF. Subscriptions and redemptions are usually facilitated in large blocks of shares known as “creation units”. The authorised participants will then make a market in the UCITS ETF shares within the secondary market on a stock exchange through which investors will buy and sell shares.

In terms of the operational infrastructure behind the UCITS ETF, the appointment of authorised participants and the negotiation of the relevant contracts with the authorised participants will be a key part of the initial launch of the UCITS ETF. Numerous authorised participants may be appointed to each UCITS ETF and the appointment may be concluded at the umbrella level, meaning the authorised participants can act for each of the sub-funds that are created within that umbrella fund.

The authorised participant agreements are not reviewed by or filed with the Central Bank.

Passive ETFs – UCITS Index Rules

Where establishing a passive ETF which seeks to track an index, whether through physical replication or synthetically via a total return swap or other similar

financial derivative instrument, it is necessary to comply with the UCITS and Central Bank requirements with respect to financial indices.

The UCITS Directive imposes rules regarding maximum exposure to any one issuer in order to ensure the UCITS portfolio is appropriately diversified. One standard rule for a UCITS, as explained above, is the “5/10/40 rule”. However, compliance with this concentration limit would make it difficult for UCITS to replicate or track certain indices. Accordingly, in the case of an index tracking UCITS, this rule is dis-applied. Instead, an index tracking UCITS is permitted to invest up to 20% of its net assets in shares or other debt securities of any single issuer and up to 35% of net assets in issuers of one issuer where this is justified by exceptional market conditions.

In addition, the UCITS may only track an index which is compliant with the UCITS requirements. In summary, an index used by a UCITS must be:

- (a) sufficiently diversified;
- (b) represent an adequate benchmark for the market to which it refers;
- (c) published in an appropriate manner (and accessible to the public); and
- (d) provided by an index provider that is independent of the UCITS.

Central Bank Index Clearance

The Central Bank operates a flexible regime with respect to the clearance of indices for UCITS. Essentially, a UCITS ETF that proposes to use a financial index for tracking, replication or investment purposes is not required to submit that index to the Central Bank for clearance if, on a “look-through” basis, it would be possible for the UCITS to directly invest in the constituents of the index as allowed by the UCITS Rules (for example, the “5/10/40” rule). In such circumstances it is simply necessary to confirm to the Central Bank during the authorization process that the index is

compliant. If it is not possible to provide this confirmation to the Central Bank or where it would not be permissible for the UCITS to invest directly in the underlying constituents of the proposed index (for example, if it is an index comprised of commodities) the UCITS ETF must submit the index to the Central Bank for clearance.

Where it is necessary to submit an index to the Central Bank, the application will need to include documentary evidence to enable the Central Bank properly assess the submission, including any technical and marketing documents produced by the index sponsor.

The application will be reviewed broadly against the criteria listed at (a) to (d) above and in particular will focus on the following points:

Diversification: In general it is necessary to demonstrate that each individual component of the index may not have a weighting greater than 20%. On a case-by-case basis the Central Bank may permit one constituent of the index to have a weighting of up to 35% but evidence as to the market circumstances that justify this position must be provided.

Adequate Benchmark: The submission must provide the rationale as to how the proposed index achieves the objective of being a benchmark for the market to which it refers. The methodology used to construct the index should be adequately described, including data on constituent selection criteria, constituent price collection procedures, asset allocation rules and guidelines for altering and re-balancing the index, its constituents and their weights. The Central Bank will also require details as to how the index calculation methodology is verified. Information on any fees embedded in the index also need to be disclosed.

Publication: The index should be published in an appropriate manner. This means that an investor should be able to access relevant material information on the index with ease, for example, via the internet. Index performance should also be freely and continually available. Information on matters such as index constituents, index calculation, re-balancing methodologies, index changes and information relating to any operational difficulties in providing timely or accurate information should also be available to the extent permitted by the index provider. Note that

information that an index provider considers to be of a proprietary and commercially sensitive nature is not expected to be published in a detailed manner.

Independently Managed: The index must be independently managed from the management of the UCITS ETF. The Central Bank will take into account the relationship, if any, between the UCITS ETF and the index sponsor. The performance of the index should be calculated in an independent environment, free from any external influences. This does not preclude index providers and the UCITS forming part of the same economic group (but conflicts of interest procedures must be in place).

Additional Index Requirements

The European Securities and Markets Authority (**ESMA**) published additional rules regarding indices in 2014. The Central Bank has incorporated these requirements into its own rules and they include:

- (i) The index should have a clear, single objective in order to represent an adequate benchmark for the market. Where a financial index has been created and calculated on the request of a single market participant, or a very limited number of market participants, and according to the specifications of that market participant or those market participants, the Central Bank shall not consider it as constituting an adequate benchmark of the market to which it refers;
- (ii) The UCITS ETF is required to carry out due diligence on the index prior to investment and on an ongoing basis;
- (iii) The UCITS ETF may not invest in an index (a) that rebalances on an intraday or daily basis (or on a frequency which prevents investors from being able to replicate the index); (b) where the index provider does not disclose in an easily accessible and free of charge format to investors prescribed details on the calculation methodology which is sufficient to enable investors to replicate the index; or (c) information on the performance of which is not freely available to investors;
- (iv) The UCITS ETF may only invest assets in a financial index (a) that publishes its constituents and weightings in an accessible manner; (b) that has

selection methodology and rebalancing based upon set pre-determined rules and objective criteria; (c) where the index provider does not accept payments from potential index components for inclusion in the index; (d) the methodology of the financial index does not permit retrospective changes to the previously published index values; and (e) the index is subject to independent valuation;

(v) With respect to commodity indices specifically, the relevant commodity index must be comprised of different commodities. Sub-categories of a commodity are regarded as being the same commodity for the calculation of the diversification limits where they are highly correlated.

Index Disclosure Requirements

It is also important to note that the Central Bank (in line with the ESMA requirements) imposes prospectus/sub-fund supplement disclosure requirements with respect to index-tracking UCITS and index-tracking leveraged UCITS. Summary information on these matters should also be included in the KIID.

Active ETFs – Disclosure and Portfolio Transparency

Active ETFs are subject to the standard UCITS eligible asset and concentration rules. However, in addition to complying with such rules, an active ETF is also subject to the following points:

Prospectus Disclosure: The prospectus of the active ETF must clarify that the fund does not track an index and that it is actively managed by the investment manager. Information should also be provided within the prospectus of how the investment manager intends to meet its investment policy including where applicable its intention to perform any index.

Portfolio Holdings Disclosure: An important point relating to the authorisation of an active ETF in Ireland relates to the Central Bank requirements with respect to the disclosure of portfolio holdings. The Central Bank has provided guidance which outlines that it will **“not authorise an ETF, including an active ETF, unless arrangements are put in place to ensure that information is provided on a daily basis regarding the identities and quantities of portfolio holdings.**

The arrangements must be disclosed in the prospectus.” While the Central Bank has clearly outlined that information must be provided on a daily basis, importantly it has not stated that such information must be publically published (i.e. it may be possible to release the information solely to the authorised participants appointed by the UCITS ETF rather than to the public at large).

General UCITS ETF requirements

All UCITS ETFs must comply with the following provisions:

- UCITS ETF Identifier – an ETF authorised as UCITS must use the UCITS ETF identifier in its name. This can be used on an umbrella level (if all of the sub-funds in the umbrella will be ETFs) or on a sub-fund by sub-fund basis.
- Treatment of secondary market investors – The prospectus of the UCITS ETF is required to include disclosure outlining that if the stock exchange value of the shares of a UCITS ETF significantly varies from the fund’s net asset value then the UCITS ETF is obliged to provide investors who have acquired their shares on the secondary market with the ability to sell their shares directly back to the ETF at their net asset value, rather than only having the option of selling them on a secondary market. In such situations, information should be communicated to the regulated markets on which the shares are traded, indicating that the UCITS ETF is open for direct redemptions at the level of the UCITS ETF. UCITS ETFs are required to disclose the process to be followed by investors in such circumstances in the prospectus, as well as the potential costs involved. The costs are not allowed to be excessive or punitive and should reflect the actual costs to the UCITS ETF of providing this service. In reality, this requirement has never been tested.
- Portfolio transparency – each UCITS ETF is required to disclose in the prospectus, KIID and marketing communications the policy regarding portfolio transparency and where information on the portfolio may be obtained, including where any indicative net asset value (iNav) is published.

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Individual Stock Exchange Listing Requirements



UCITS ETFs are typically listed on some of the key European exchanges. With each UCITS ETF often cross-listing shares across various exchanges. These exchanges include the London Stock Exchange (typically via a passport with the Irish Stock Exchange), the Frankfurt Stock Exchange (Deutsche Bourse), the Swiss SIX Exchange and the Borsa Italiana. Each exchange has its own individual requirements with respect to obtaining a listing which the UCITS ETF must meet. For example, the Deutsche Bourse, SIX and Borsa Italiana require the publication of an **iNAV** at set frequencies (usually between every 15 to 60 seconds). The iNAV is an estimate of the value of a share based on the relevant day's holdings in the UCITS ETF. It enables investors buying and selling shares on the exchange to determine whether the market price of the shares is a fair reflection of the price of the UCITS ETF's holdings. Similarly each exchange will have its own portfolio holdings disclosure requirements.

In advance of listing the UCITS ETF, it is necessary to ensure that the UCITS ETF has been passported appropriately within the EU jurisdiction, or registered for sale as appropriate in the non-EU jurisdiction (for example Switzerland). The EU passport is a straightforward ten day regulator-to-regulator notification process.

It is also important to note that each individual stock exchange will have its own clearing and settlement system. Some of the systems provide for the trading and settlement of shares in "dematerialised" form (shares which are transferred without requiring the transfer to be evidenced by written transfer of ownership). For example, the London Stock Exchange utilises an electronic share settlement system known as CREST which provides for real time settlement of securities traded on the LSE and the ability to hold securities in a dematerialised form.

Other clearing and settlement systems facilitate the trading and settlement of shares which are "immobilised" (one single global share certificate is issued and held in a depositary within the system with that global certificate marked up and down as appropriate to record changes in the underlying holdings).

The UCITS ETF must be established so that it can issue shares in whatever format is required by each individual stock exchange.

More recently, an international centralised securities depositary has been introduced into the market which will facilitate the centralised settlement of all shares in the UCITS ETF, regardless of listing location.



Dechert's Global Expertise in ETFs

Dechert's Financial Services Group has a leading ETF practice, comprised of lawyers that have expertise in ETF fund formation and the development of new products in the Europe, the United States and Asia.

Dechert has the extensive reach, resources and practical expertise to serve to the financial services industry. We represent 18 of the 20 leading global asset managers in some capacity, including a significant percentage of the universe of ETF sponsors. Our lawyers are experienced advisors on ETF fund formation and the development of new products in the Europe and the United States as well as on related regulatory matters.

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