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ETFs 2015
Exchange Traded Funds

Leading business advisers

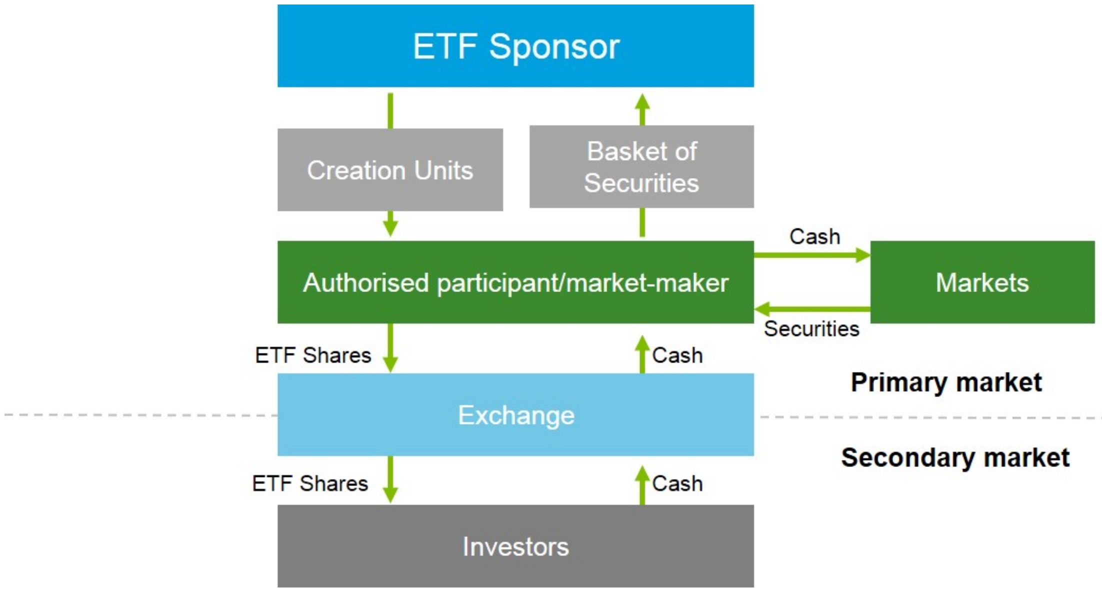
Introduction

ETFs are fund structures whose units are traded on regulated markets and investment exchanges. They are typically open-ended and redeemable on a daily basis. Most European ETFs are structured as UCITS funds.

ETFs originated in the 1990s as a cost and tax efficient alternative to mutual funds. They have traditionally been structured as passively managed index tracking funds which aim to replicate indices (such as the FTSE 100 or S&P 500). They can be physical (where the fund invests directly in the underlying assets that comprise the index) or synthetic (where the fund gains exposure to the index by entering into a swap agreement with a counterparty). In theory, the fluctuations in the value of the shares iheld should duplicate any fluctuations to the index.

The diagram below is an extract from the April 2011 Bank of International Settlements ("BIS") working paper on market structures and systemic risks of ETFs. It illustrates the operation of an ETF which uses physical replication. An authorised entity (the Marketmaker) purchases a basket of securities and delivers them to the fund manager in exchange for 'creation' units, ie, large blocks of ETF shares. The Marketmaker lists the ETF creation shares on an exchange. Investors trade the shares of the ETF through this exchange. The net asset value (NAV) of the ETF is determined by the market value of the basket of securities held by the ETF sponsor.

Figure. 1 Operational structure of ETFs



In recent years, ETFs have developed from their original passively managed format. Products such as 'leverage' and 'smart beta' ETFs are now being launched. 'Leverage ETFs' offer leverage under the ETF umbrella and deliver returns that are multiples of the daily performance of the index they track. Similarly, the leverage inverse ETF seeks to deliver a return that is a multiple of the inverse performance of the underlying index. 'Smart beta ETFs' track an index using methods other than the traditional weighted method.

Modern ETFs are also being structured as actively managed, where the manager retains discretion over the portfolio composition rather than tracking an index.

UCITS

In Europe, ETFs have typically been structured as UCITS to enable them to benefit from the UCITS passport. They consequently must comply with the UCITS rules on portfolio composition and eligibility of assets.

The 5/10/40 rule prohibits UCITS from investing more than 10% of its net assets in transferable securities (or money market instruments) issued by a single entity, as long as the total value of shares it can hold in entities in which it can invest more than 5% is less than 40%.

Index tracking enjoy slightly more freedom under the 20% and 35% rule. An index-tracking ETF may invest up to 20% of its net assets in ETFs shares/debt securities issued by the same body, or 35% where the index is recognised by the Central Bank of Ireland (CBI), it is sufficiently diversified, represents an adequate benchmark for the relevant market and is published in an appropriate manner.

Physical ETFs must ensure that the shares they hold comply with the UCITS eligible asset rules. This would preclude them from tracking an index of commodities.

The European Securities and Markets Authority has issued Guidelines on ETFs and other UCITS issues, as well as a related Q&A document.

These require all UCITS ETFs to disclose that they are ETFs. Index-tracking UCITS ETFs must also prominently disclose their promoted material that they track and index as well as details of the relevant index. Actively managed UCITS ETFs must disclose that they do not track an index and that they are actively managed.

Listing

The Irish Stock Exchange (ISE) claims to be the No. 1 exchange globally for listing investment funds and has an active market in listing and trading Irish UCITS EFFs. The ISE's efficient, low cost listing process minimises the time and resources required for an EU Regulated Market listing. The ISE hosts world class trading and post-trade infrastructure and leading specialist ETF market-making firms. European ETFs listed on the ISE can apply directly to the London Stock Exchange for admission to trading on its Main Market without needing to obtain a separate LSE listing. This cost efficient admission process is available only to ETFs already listed on an EEA stock exchange.

Listing process on the ISE

Establish fund

- ✓ Seek regulatory approval from the Central Bank/ relevant regulator
- ✓ Apply to the ISE for listing approval and the ISIN codes

Listing approval

- ✓ The ISE reviews prospectus within two business days
- ✓ Shares are listed on the Main securities market (an EU regulated market) of the ISE

Admission to Trading

- ✓ Direct admission to the relevant market can take place
- ✓ Requirements include:
  - Financial Conduct Authority fund recognition
  - Approved prospectus stamped by the ISE

Tax

Ireland's attractiveness as an ETF domicile is due to several factors, including Ireland's extensive network of tax treaties with key jurisdictions worldwide which enables ETFs to access the double taxation treaties where the fund is demonstrated to be trading. In particular, Irish ETF's can benefit from the USA/Ireland double tax treaty which reduces withholding tax to zero on interest and 15% on dividends.

Irish funds, including ETFs, are not subject to Irish taxation on any income or gains realised from underlying investments. They are also exempt from withholding tax.   Similarly, no stamp duty regarding shares in an ETF, or on the underlying shares it holds (as long as those underlying shares are not issued by an Irish registered company, do not relate to Irish property). ETFs can also enjoy beneficial VAT exemptions.

Ireland's ETFs

Ireland is the domicile for almost 50% of ETFs. Irish ETFs have been structured with the VCC the most popular vehicle of choice to date. It is possible that the new ICAV structure may be used for future launches.

Regulatory focus

The Financial Stability Board noted that the ETF market has grown at an average of 40% since 2000 and that the global ETF industry has over US1.2 trillion in assets under management. Due to this growth and to ensure investor protection, ETFs have been the focus of regulation by bodies such as IOSCO and IMF. ESMA has issued guidelines and Questions and Answers documents, while the CBI has issued a Consultation Paper on the adoption of ESMA's revised guidelines on ETFs and other UCITS issues (CP84).

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