

CONTENTS

UCITS ETFs	1
Non-UCITS ETFs	1
Closed-ended ETFs	2
10% Unlisted Bucket	3
Conclusion	3
Key Contacts	3

THE ELIGIBILITY OF AN ETF FOR INVESTMENT BY A UCITS FUND

The proliferation of exchange-traded funds (“ETFs”) established in the US and in recent times in Europe and their increasing popularity in the current volatile stock market environment has meant that they are frequently considered as a possible asset class for investment by other funds. The purpose of this article is to consider how an ETF is categorised for eligibility for investment by a UCITS fund and, as explained below, this depends on whether the ETF is an open-ended collective investment scheme and a UCITS itself or a closed-ended collective investment scheme. The percentage of a UCITS fund’s net asset that can be invested in an ETF varies and also depends upon this categorisation.

UCITS ETFs

If a UCITS fund wishes to invest in an ETF which is an open-ended collective investment scheme¹ then the ETF itself must either be a UCITS fund or have the characteristics of a UCITS fund.² A significant proportion of ETFs established in Europe have been established as UCITS funds in either Dublin or Luxembourg and so if an ETF in which a UCITS wishes to invest is a UCITS itself authorised in either of these two jurisdictions then such an investment is acceptable provided however that the ETF has either in its prospectus or its constitutional document a limitation on its investment in other collective investment schemes of up to 10% of the ETF’s net asset value. If this limitation exists then the UCITS can invest in the ETF and may invest up to 20% of its net asset value in a single ETF.

Non-UCITS ETFs

If the ETF in which a UCITS wishes to invest is a non-UCITS fund a more detailed examination of the characteristics of the ETF is needed in order to decide if the ETF is an eligible investment. In this situation the ETF must meet a number of requirements. The ETF must have as its sole object the collective investment in transferable securities and/or in other liquid financial assets of capital raised from the public and operate on the principle of risk spreading. In addition, the units of the ETF must at the request of the unitholder be repurchased or redeemed directly or indirectly

¹ Other than by way of using the 10% unlisted bucket as described below.

² As required by Regulation 45(e) of the UCITS Regulations.

out of the ETF's assets.³ The second limb of the requirement may be problematic if the dealing arrangements of the ETF are such that only a basket or tranche of shares (usually comprising of a large number of shares) may be subscribed for or redeemed. In many ETFs this is the only way in which investors can deal with the ETFs directly. The Regulator considers that where this is the case this second requirement may not be satisfied. The ability of individual investors to deal in smaller numbers than the basket or tranche of shares on the secondary market by virtue of an ETF's listing does not address this issue as it does not constitute dealing at the request of unitholders with the fund itself.⁴

In addition to the requirements above in order for an ETF established as a non-UCITS fund to be an eligible investment for a UCITS the ETF must meet further criteria set out in the Regulations and the Financial Regulator's Guidance Note 2/03.⁵ Essentially these requirements ensure that the non-UCITS ETF has the key characteristics of a UCITS. The ETF must be subject to a regulatory regime which ensures that the level of protection for unitholders is equivalent to that provided for unitholders in a UCITS and in particular that the rules on segregation of assets, borrowing, lending and uncovered sales of transferable securities and money market instruments are equivalent to the requirements of the UCITS Directive. Secondly, the ETF must be authorised under laws which provide that it is subject to supervision considered to be equivalent to that of the Financial Regulator and there must be cooperation between the regulatory authorities.

Lastly, in order for the ETF to be considered an eligible investment the ETF itself must limit in either its prospectus or its constitutional document its investment in other collective investment schemes to 10% of its net asset value. Many ETFs, and particularly those established in the U.S., may not have this restriction on investment in other schemes and are therefore ineligible for investment under this category of investment. If the ETF is a non-UCITS which satisfies all of these requirements described above the UCITS may invest up to 20% of its net asset value in a single ETF.

Closed-ended ETFs

To the extent that an ETF is a closed-ended collective investment scheme different criteria apply when considering the eligibility of the ETF as an investment for a UCITS. The applicable rules are derived from the Eligible Assets Directive.

The ETF must:

- (a) be regarded as a transferable security;
- (b) be subject to corporate governance mechanisms similar to those that apply to companies; and
- (c) where the asset management activity is carried out by another entity on behalf of the ETF, that entity must be subject to national regulations.

In order for the ETF to be a transferable security it must meet the following requirements:

- (i) the potential loss which the UCITS may incur with respect to holding units in the ETF is limited to the amount paid for them;
- (ii) the liquidity of the ETF must not compromise the ability of the UCITS to comply with its obligation to meet redemption requests;
- (iii) there must be reliable valuation of the ETF on a periodic basis;
- (iv) there must be regular and accurate information available to the UCITS on the ETF;
- (v) the investment must be consistent with the stated investment objective of the UCITS; and
- (vi) the risks of the investment must be adequately captured by the risk management process of the UCITS.⁶

Where an ETF established as a closed-ended fund meets these requirements the usual diversification limits apply and so a UCITS may invest up to 10% of its assets in the ETF. In this case the investment by the UCITS would also be subject to the usual 5/10/40 diversification rule (i.e. that the total value of the issuers in which the UCITS invests more than 5% of its net asset value must not exceed 40% of the UCITS net asset value).

³ Regulation 3(2) of the UCITS Regulations.

⁴ This does create an anomaly because if the ETF is a UCITS fund no further analysis need be done on how the redemption facilities operate.

⁵ Regulation 45(e) of the UCITS Regulations.

⁶ Article 1(8) of the UCITS Directive.

10% Unlisted Bucket

A UCITS may invest up to 10% of its net assets in unlisted transferable securities and money market instruments, commonly known as the “10% unlisted bucket”.⁷ The Financial Regulator recently issued guidance on the range of investments in which a UCITS could invest in this category. This “10% unlisted bucket” may now comprise of unregulated funds. It is therefore possible for a UCITS to invest in an ETF by classifying its investment in this category. This may be particularly useful if an ETF fails to satisfy any of the requirements set out above (for example, for a non-UCITS ETF because of the dealing in tranches of shares or perhaps because the ETF does not have the 10% restriction on investment in other schemes). However the use of the “10% unlisted bucket” for investment in an ETF does then limit the use of this category by the UCITS for other possible types of investment it may wish to make.

Conclusion

Investment by a UCITS in an ETF requires analysis to be carried out as to whether the ETF is open-ended and a UCITS or similar to a UCITS or closed-ended. Maximum flexibility is afforded to an investment in an ETF - up to 20% of a UCITS net asset value in a single ETF - if the ETF is a UCITS or has all of the key characteristics of a UCITS. Otherwise the investment by a UCITS in an ETF is limited to 10% of the UCITS net asset value.

⁶ Article 1(8) of the UCITS Directive.

Key Contacts

Should you wish to receive further information on these changes, please contact one of the following partners:

Carl O’Sullivan
Tel: +353 1 618 0525
carl.osullivan@arthurcox.com

Sarah Cunniff
Tel: +353 1 618 0508
sarah.cunniff@arthurcox.com

Kevin Murphy
Tel: +353 1 618 0515
kevin.murphy@arthurcox.com

Kevin O’Connor
Tel: +353 1 618 1140
kevin.oconnor@arthurcox.com

DUBLIN

Earlsfort Centre
Earlsfort Terrace
Dublin 2
Ireland

T: +353 1 618 0000
F: +353 1 618 0618

mail@arthurcox.com
www.arthurcox.com

BELFAST

Capital House
3 Upper Queen Street
Belfast BT1 6PU
Northern Ireland

T: +44 28 9023 0007
F: +44 28 9023 3464

LONDON

12 Gough Square
London EC4A 3DW
England

T: +44 20 7832 0200
F: +44 20 7832 0201

NEW YORK

300 Park Avenue
17th Floor
New York NY 10022
USA

T: +1 212 705 4288
F: +1 212 572 6499