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## ■ EXCHANGE-TRADED FUNDS

The first exchange-traded fund (“ETF”) in Dublin which was launched by Merrill Lynch International using a UCITS umbrella investment company with variable capital. Arthur Cox represented the promoter in establishing this fund.

The ETF was an index tracking fund (based on the Dow Jones STOXX 50 Index) listed on an exchange (the Deutsche Börse) which could be traded intra-day (through Clearstream). The development of ETFs has resulted from the desire to create a product that allows trades of a basket of stocks to be effected in a single transaction at a relatively low cost throughout the trading day.

There are now some 480 ETFs established in Europe representing US\$154 billion of assets under management, many of which are established as UCITS funds domiciled in Dublin and Luxembourg. This article examines the key characteristics of ETFs and why many regard them as particularly attractive in the current market conditions.

### Diversification

ETFs comprise of a basket of securities and therefore provide diversification across an index. They allow investors to capture the diversity they seek by investing in the companies comprised in a particular index tracked by the sub-fund thereby providing investors with access to the stocks they need in their portfolios without their having to buy shares in all of the companies in the index themselves which is a costly and time-consuming process.

Whilst the first ETFs tracked equity indices they now include an array of different asset classes and ETFs can be established to cover any asset that has a published index. ETFs have been established which provide exposure to fixed income, real estate and commodity indices and have also been established as regional and country funds. ETFs provide the flexibility, ease and liquidity of stock trading with the benefits of traditional fund investing.

### Transparency

ETFs provide investors with an element of transparency which is not available in an actively-managed fund. Investors who may now have concerns about the transparency and liquidity that the more sophisticated funds investing in structured products offer may prefer a more straightforward product which replicates an index simply by buying the underlying

securities of the index. The market price of an ETF's shares is disseminated in the secondary market on a continuous basis throughout the trading day and the identity and number of shares required for the creation and redemption of shares is available from the administrator of the ETF on a daily basis. As a result the content of the portfolio of an ETF is likely to be well known. By contrast, the portfolio of an actively-managed fund is secret. An investor in an ETF is also able to estimate the net asset value of the shares during periods when the net asset value is not actually calculated and published by the fund itself. The availability of this information about the nature of the portfolio and the ability to purchase shares throughout the day provides institutional investors with an opportunity to execute arbitrage transactions based on differences between the price of the individual shares in the secondary market and the net asset value of the shares.

## Dealing flexibility

The entry and exit mechanisms for ETFs operate on two levels. Shares in an ETF are typically issued in blocks of shares. Both entry and exit into the ETF at this level is almost exclusively in kind, i.e. an investor provides, in the case of a subscription, and receives, in the case of a redemption, shares representing the basket of stocks in the particular index which the sub-fund tracks. This method of entry and exit into the sub-fund has meant that ETFs are for the most part bought and sold by institutional investors and market makers. At this level the shares are subscribed for and redeemed at their net asset value. However the cross-listing of the shares on stock exchanges, such as Euronext and Deutsche Börse in Europe, and the trading of the shares in Europe through Euroclear and Clearstream allows individual shares (as opposed to blocks of shares) to be bought and sold for cash on the secondary market at the prevailing market price of the shares on that secondary market. The purchase and sale of shares in the secondary market takes place without the investor having to interact with the ETF itself. The real benefit of the secondary market trading for the investor is that individual shares (and not blocks of shares) may be bought and sold on this market at any time throughout the trading day unlike, in the case of a fund, where

shares can only be issued and redeemed at one particular time on the dealing day at their net asset value. The shares can be created and redeemed at their daily net asset value through the fund but purchased and sold at their market price at any time throughout the day.

## Lower costs

The real advantage of an ETF over a traditional index tracking fund is its low cost. ETFs generally have significantly lower annual expense ratios than other investment products. The management charges for ETFs are less than that typically charged for actively-managed funds because they are index-based and the turnover of the portfolio is less frequent. Since ETFs trade on one or more exchanges they avoid the cost of having to buy and sell securities in the portfolio to accommodate shareholder dealings, unlike a traditional fund. Also, the in-kind subscription and redemption procedures eliminate the need for ETFs to buy and sell the underlying securities and the attendant costs of doing so. In addition, only small transaction charges for entry into ETFs are payable compared to the usual entry and exit charges levied on investors by typical funds. The popularity of ETFs, and index-tracking funds generally, have been the focus of press comment in recent months. In the current highly volatile stock market conditions there is a realisation among investors that fund managers often fail to match, let alone outperform, indices.

## Pan-European distribution of UCITS ETFs

Many of the ETFs established in Europe are Dublin or Luxembourg domiciled UCITS funds which use the established framework of the European passport to distribute in the major European Member States. The registration of an ETF across the target EU member states is often a costly and time-consuming exercise and so does present a challenge for promoters. Although the registration process is intended to be the same in each European jurisdiction the requirements of some jurisdictions are more cumbersome than others. Fitting the product into the requirements of the UCITS regime means that the investors are treated as if they are retail-type investors whereas ETF investors tend to be sophisticated market

makers. In most jurisdictions local paying agents need to be appointed to provide a contact point for investors in a particular jurisdiction through whom requests can be made to provide information about the ETF, to pay dividends and provide redemption facilities. The appointment of these agents who are rarely, if ever, used inevitably

involves fees and legal work that does not add real value to the investors of the ETFs. It is of course hoped that some of these timing and cost concerns will be addressed in the more streamlined distribution model that is proposed under the UCITS IV Directive.

### Key Contacts

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