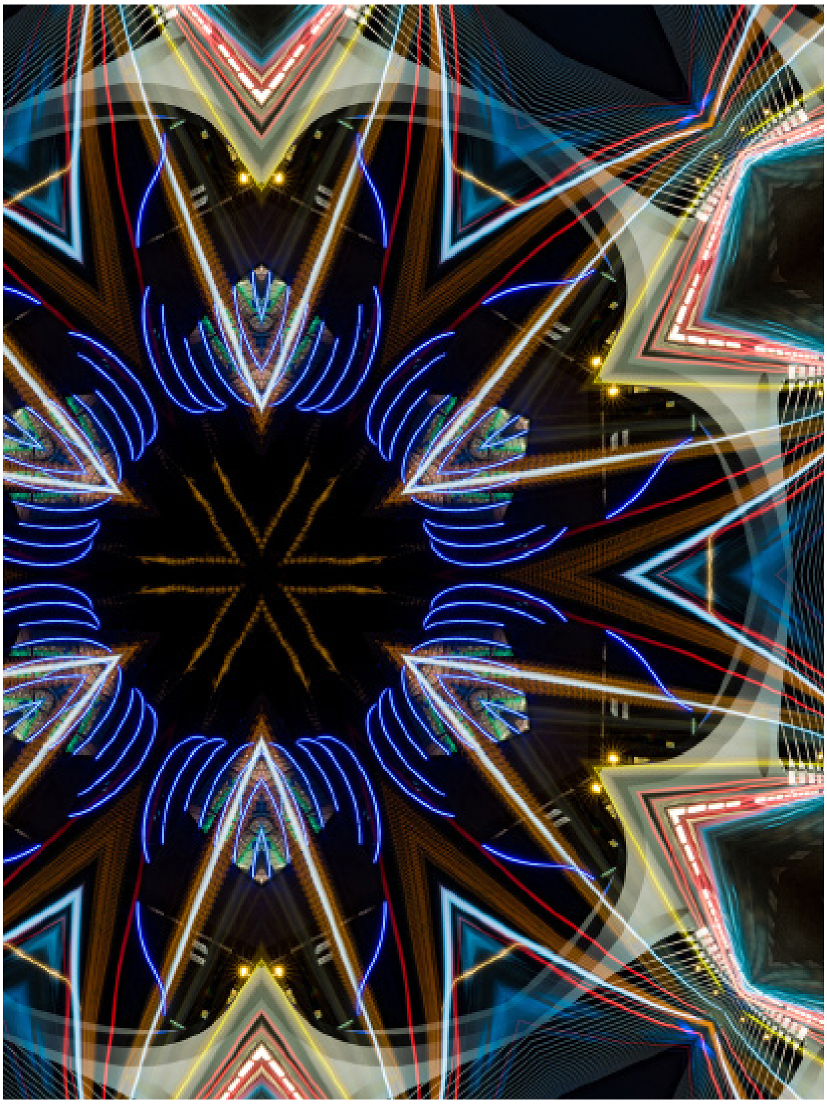
ARTHUR COX



ASSET MANAGEMENT AND INVESTMENT FUNDS

# A Manager's Guide to Establishing an ETF in Ireland

# Why Ireland?

In 2024, ETFs in Ireland topped $1.7 trillion, representing more than 70% of the European ETF market, and it is the European domicile of choice for the world's leading ETF managers. Why?

- Ireland is a **centre of excellence** for European ETFs with:
  - unrivalled expertise in ETF servicing;
  - a strong regulatory framework;
  - government, regulator and industry support; and
  - a favourable tax regime[1];
- Ireland provides managers with unfettered **access to investors in the European Economic Area (EEA)** via the UCITS passport regime which enables more efficient admission to listing and trading throughout the EEA; and
- Ireland is the **ETF domicile of choice for investors** in the United Kingdom, the Nordic region and Switzerland and the Irish-domiciled UCITS ETF is a familiar vehicle for distribution in LATAM, particularly Mexico and Chile.

## WHY ARTHUR COX LLP?

While establishing a UCITS ETF in Ireland has many benefits, entering the European market may pose challenges to US and, indeed, any non-European managers, unfamiliar with the regulatory framework and set-up processes.

Arthur Cox LLP, with the most experienced and deepest ETF team of any legal service provider in Ireland, is uniquely placed to help you navigate these challenges. Together, the ETF team at Arthur Cox LLP has launched some of the largest ETF platforms in Europe as well as platforms for boutique managers. From our role in the establishment of the first ETF in Ireland in 2000 to now, we have taken the lead on all product developments in the ETF space, so we can help you navigate the required elements from engagement and service provider selection through to cross-border listing.

1 As well as potentially benefitting from a reduced level of withholding tax for US equities due to the Ireland-US double tax treaty, Irish ETFs are not subject to any Irish tax (though Irish investors in an Irish ETF would be subject to tax).

## WHAT IS THE STRUCTURE OF AN IRISH ETF?

### Legal Structure – Standalone v Umbrella and Choice of Vehicle

Irish ETFs may be established as a single (standalone) fund or as an umbrella fund comprising one or more sub-funds, each sub-fund with a different investment objective and policy. Sub-funds within an umbrella fund may have exposure to different indices or asset types and each sub-fund will have segregated liability from the other (such that the assets of one sub-fund cannot be used to discharge the liabilities of another).

A sub-fund may comprise different classes of shares allowing for different fee structures, dealing amounts, hedging strategies and currencies and facilitating different distribution channels. Irish ETFs may have listed and unlisted share classes and can benefit from derogations from certain of the Central Bank's requirements relating to dealing.

Irish ETFs – either standalone or umbrella – can be housed in a number of different vehicles, including corporate vehicles or trusts, though the vehicle of choice is the Irish Collective Asset-management Vehicle ("**ICAV**"). The ICAV is a corporate vehicle which was introduced in 2015 and has been specifically tailored to the needs of the global funds industry.

A significant advantage of the ICAV is that, if it elects to do so, it can meet the US "check the box" taxation rules. The ICAV can elect in its classification under the U.S. "check the box" taxation rules to be treated as a transparent entity for US federal income tax purposes which will allow US taxable investors to avoid certain adverse tax consequences that would normally apply to "passive foreign investment" companies.

For the remainder of this Guide, we refer to an ICAV structure. For information on any differences that would arise should another vehicle be chosen, please contact us.

## Regulatory Status - UCITS

Irish ETFs are generally structured as UCITS[2], a regulated product authorised by the Central Bank of Ireland (the "**Central Bank**"). Irish ETFs are required to be identified with "UCITS ETF" and this identifier must be included in the name of any ETF sub-fund.

As UCITS, Irish ETFs are subject to diversification requirements designed to protect investors and may only invest in UCITS eligible assets or, in the case of index-tracking ETFs, may only use UCITS eligible financial indices. For further information, please refer to "***What are the Product Considerations?***" below.

While Ireland was traditionally host to physical long-only equity and bond index ETFs, the current universe of ETFs in Ireland reflects the wide variety in ETFs globally, including smart beta ETFs, active ETFs, thematic ETFs, leveraged and inverse ETFs, ESG ETFs and option strategy ETFs, all housed within the UCITS structure. Irish ETFs may offer physical exposure, use derivatives to gain synthetic exposure or use a combination of physical and synthetic exposure and may offer leverage and inverse exposure.

As a regulated product designed for retail investors, the initial authorisation of Irish ETFs and subsequent changes or future product developments are subject to the review and approval of the Central Bank. The timing of the review process can vary depending on the complexity of the Irish ETF proposed.

## Day-to-Day Management

The day-to-day management and control of an Irish ETF rests with a board of directors (the "**Directors**"). There must be a minimum of two Irish resident Directors and all Directors are approved by the Central Bank prior to being appointed.

While the Directors have ultimate responsibility, they may have delegate tasks. Specifically, ICAVs appoint an external UCITS management company to perform, on a delegated basis, certain functions of the Directors subject to the overall oversight and control of the Directors and the UCITS Management company is the "responsible person" for certain matters for the Irish ETF under Irish regulation.

The functions delegatred generally comprise portfolio management, risk management, distribution and administration. The UCITS management company in turn may delegate these functions to a variety of other service providers, as further detailed below.

## Delegation and Appointment of Service Providers

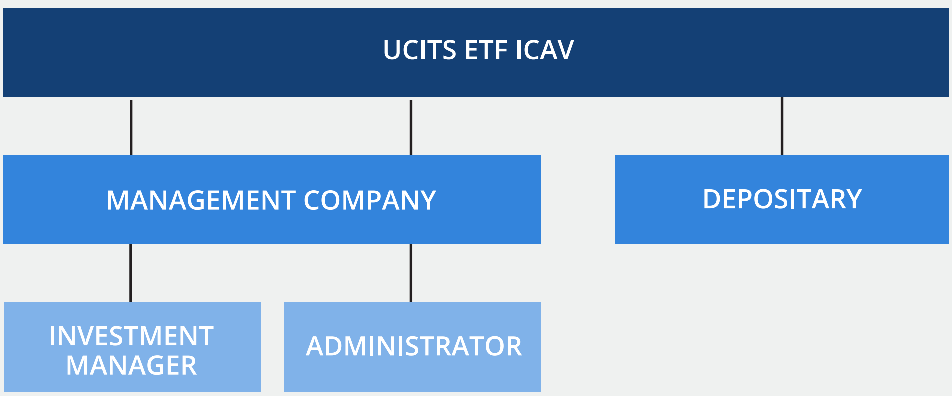
The ICAV must appoint a single independent depositary. The depositary has two broad functions, being: (i) to safekeep the assets of ICAV; and (ii) to oversee compliance with the constitutional documents and applicable rules and law. The depositary must be an EU credit institution or authorised to carry out depository activities and must be authorised by the Central Bank to act as a depositary to an Irish investment fund. The appointment of the depositary must be evidenced in an agreement with the ICAV and the UCITS management company must ensure that a depositary has been appointed.

As mentioned above, the UCITS management company generally onward delegates its functions to one or more portfolio managers, an administrator and one or more distributors. In order to effect the delegation, the UCITS management company must demonstrate that it can monitor and oversee these functions at any time, it can instruct the delegates at any time and it can withdraw the delegation,if required in the interests of investors.

It is often the case that the US managers seeking to establish an Irish ETF will be appointed as the Irish ETF's portfolio manager. Any entity seeking to act as a discretionary portfolio manager for an Irish authorised investment fund must receive prior clearance from the Central Bank. This process must be completed prior to any application for authorisation of the Irish ETF by the Central Bank. SEC regulated managers will find the process very straightforward.

2 Undertakings for collective investment in transferable securities.

**Taken together, the typical structure of an Irish ETF is as follows:**




The management company can be a third party management company or can be a proprietary management company established in conjunction with the ETF or passported from another EU jurisdiction.

### Core Documentation

The core documentation required for an Irish ETF includes, but is not limited to:

| DOCUMENT | PURPOSE |
|---|---|
| **Instrument of incorporation** | The constitutional document of the ICAV required to register the ICAV with the Central Bank and setting out the rules with which the ICAV must comply. |
| **Prospectus** | The core offering document setting out general information relating to an investment in the ICAV. The prospectus is subject to the review of the Central Bank prior to the ICAV being authorised as a UCITS. |
| **Supplement** | A supplement to the prospectus setting out specific information on a sub-fund. The supplement is subject to the review of the Central Bank prior to any sub-fund being authorised as a UCITS. |
| **Depositary Agreement** | The contractual arrangement relating to the appointment of the depositary |
| **Management Agreement** | The contractual arrangement relating to the appointment of the external UCITS management company. |
| **Service Provider Agreements** | The contractual arrangements relating to the appointed by the external UCITS management company of the portfolio manager(s), administrator and/or distributor(s). |

## WHAT ARE THE OPERATIONAL CONSIDERATIONS?

It is necessary to set-up operational elements of an Irish ETF for it to comply specific ETF regulatory requirements.

In this regard, the Central Bank defines as ETF as follows:

***A UCITS at least one share class of which is traded throughout the day on at least one regulated market or multilateral trading facility with at least one market maker which takes action to ensure that the stock exchange value of its shares does not significantly vary from its net asset value and where applicable its indicative net asset value.***

### Market Makers and Authorised Participants

Other than the listing and trading of shares on a regulated market or multilateral trading facility which is deal with in further detail below, the main operational consideration is the appointment of at least one market maker and authorised participants. The appointment of authorised participants and the negotiation of the authorised participant agreement is a key feature of the initial launch of an Irish ETF. While authorised participant agreements are neither reviewed by nor filed with the Central Bank, the Central Bank, during its review of the proposed Irish ETF for approval, may request details of proposed authorised participants.

Of particular important is the due diligence of authorised participants and market makers when onboarding them and the conduct of ongoing monitoring regarding, among other things, the functioning of effective arbitrage and liquidity.

### Indicative Net Asset Value

Unlike other jurisdictions, the Central Bank does **not** mandate the calculation of an indicative net asset value. If, however, an indicative net asset value is calculated and published, the prospectus must disclose how this is calculated and how frequently.

Any decision to employ an indicative net asset value should take into account IOSCO's views on the means to enhance the accuracy and usefulness of it.

### Portfolio Transparency

While the majority of Irish ETFs currently publish their portfolio holdings on daily basis, the Central Bank does permit more periodic disclosure of portfolio information. The Central Bank is agnostic as to the portfolio transparency model implemented by ETF managers provided that the chosen model is appropriate to ensure effective arbitrage and that there is public disclosure of portfolio information within thirty (30) business days of the end of each calendar quarter.

## Clearing and Settlement

The European capital markets are diverse and subject to complex legal, fiscal and regulatory frameworks implemented and supervised by a large number of regulators and supervisory bodies. For example, compared to the US, there are 35 major stock exchanges across the EEA, the UK and Switzerland compared to three in the US, 18 CCPs compared to one in the US, 14 local currencies compared to one in the US and, significantly, 31 CSDs compared to two in the US.

The difference is market infrastructure is a key operational consideration, specifically the manner in which shares in an Irish ETF are cleared and settlement.

Ireland does not have its own CSD and, prior to March 2021, the CSD for Irish securities was CREST. As a result of the UK's decision to leave the EU, the CREST system was no longer authorised to act as CSD in Ireland due to its operator, Euroclear UK and Ireland Limited, being a UK-domiciled company passporting into Ireland under European law. As a result, all Irish ETF issuers in existence at the time took steps to migrate to an international CSD model operated by Euroclear in Belgium and/or Clearstream in Luxembourg. All entrants to the Irish

ETF market have launched onto the international CSD model. The choice of international CSD for the clearing and settlement of shares in an Irish ETF is a key consideration to be made by managers entering the market.

## Fees and Expenses

As a low-cost product, Irish ETFs generally employ an "all-in-one" total expense ratio ("**TER**") out of which the fees and expenses of the ETF's service providers (see above for further information) are paid. The TER has been subject to recent regulatory scrutiny, in part due to European-level and Central Bank focus on undue costs and charges in UCITS structures, and so when structuring an Irish ETF, due consideration must be given to the fees and expenses to be charged and how those fees and expenses compare to competitor products, if any. It is incumbent on the Directors to keep the fees and expenses of the ETF under review for appropriateness on at least an annual basis.

> "Arthur Cox has a deep ability to understand complicated structures and transactions and provide practical and effective advice on tight timelines."
>
> **Chambers Global: The World's Leading Lawyers for Business, 2023**

## WHAT ARE THE PRODUCT CONSIDERATIONS?

### Permitted Investments and Diversification

As mentioned above, as UCITS, Irish ETFs may only invest in eligible assets and are subject to a number of diversification requirements. The key diversification requirement is the 5/10/40 rule which mandates that a UCITS may invest no more than 10% of its net assets in the securities of any one issuer and that any investments greater than 5% must not, in aggregate, exceed 40%.

### Index Tracking ETFs

Physical Index tracking ETFs fall into two broad categories, being full replication and sampling. Irish ETFs which employ a full replication strategy may benefit from a derogation from the 5/10/40 rule outlined above and, in doing so, may invest up to 20% of net assets in the securities of any one issuer and up to 35% of net assets in the securities of one issuer where this is justified in exceptional market circumstances (such as, but not limited to, market dominance). Irish ETFs may also employ a synthetic replication strategy.

Regardless of the manner in which an index is tracked, Irish ETFs must only track UCITS eligible indices. For an index

to be considered UCITS eligible, it must meet the following requirements:

- it must be **sufficiently diversified;**
- it must represent an **adequate benchmark** for the market to which it refers;
- it must be **published in an appropriate manner**; and
- it must be **independently managed**.

Due diligence must be carried out prior to use of an index and on an ongoing basis thereafter. Part of this due diligence should be an assessment of eligibility.

The Central Bank no longer reviews financial indices for eligibility. Rather, the UCITS management company (for further information, please see above) must either confirm or certify to the Central Bank that an index is UCITS eligible.

The prospectus for an Irish ETF must include a clear description of the index being tracked, information on how the index will be tracked, the implications of the chosen method of replication, a description of the factors likely to affect the ETF's ability to track the performance of the index and information on the level of anticipated tracking error.

### Active ETFs

The number of actively managed Irish ETFs is growing. Actively managed ETFs cannot benefit from the increased diversification limits available to fully replicating index tracking ETFs and are subject to the standard UCITS eligible assets and diversification requirements.

While also available to index tracking funds, the Central Bank's policy on periodic portfolio transparency (as outlined above) can be a useful consideration for managers looking to enter the active ETF space in Ireland. This can be useful in considering , the need to protect proprietary information, while giving flexibility as to the model of disclosure to facilitate the need for intra-day market making. This can allow for greater comfort in assessing the suitability of an actively managed investment strategy for exchange trading.

The prospectus for actively managed Irish ETFs is subject to different disclosure requirements from the index tracking equivalent and, as a result of not tracking an index, the information on how the portfolio manager intends to meet the investment objective of the actively managed ETF is generally extensive.

### Environmental, Social and Governance

Since March 2021, the Sustainable Finance Disclosure Regulation ("**SFDR**") has been in force across the European Union. The purpose of SFDR is to provide greater transparency around sustainability-related information with a view to channelling private capital towards a sustainable future. SFDR is, therefore, primarily a disclosures regulation which introduced classifications for ESG-related financial products, including investment funds.

Under SFDR investment funds, including Irish ETFs, can be classified as Article 8 funds (being funds which promote environmental or social characteristic) and Article 9 funds (being funds which have sustainable investment as their objective).

Funds may also be neither Article 8 nor Article 9 (colloquially referred to as Article 6 funds).

Since the coming into force of SFDR, there has been a proliferation of ESG ETFs (i.e. those classified as Article 8 or Article 9) due to ever-growing investor demand for products with environmental or social advantages.

For further information on SFDR or the integration of ESG by ETFs, please contact us.

## LISTING AND TRADING

As is the case in the US and as highlighted in the Central Bank's own definition of ETF as outlined above, at least one share class in an Irish ETF must be listed and traded on a regulated market or multilateral trading facility.

Irish ETFs are most commonly traded on one or more of: London Stock Exchange, Euronext (Paris/Amsterdam), Borsa Italiana,

SIX Swiss Exchange and XETRA (segment of Deutsche Borse). Ireland, through its stock exchange (Euronext Dublin), benefits from admission to trading rights on the London Stock Exchange. The costs of listing are generally not significant however ease of settlement and the cost of market making vary on a market-by-market basis.

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