

# Exchange Traded Funds

## Physical, Synthetic, Passive and Active Products

Exchange Traded Funds (ETFs) have seen extraordinary growth in recent years and this is a trend which is expected to continue. There is estimated to be over US\$2 trillion invested in ETFs globally and over US\$350 billion in Europe. Ireland has been recognised as a leading domicile for European ETFs with Irish domiciled ETFs representing approximately 44% of the total European ETF market<sup>1</sup>. The increase in focus on index-tracking investing has led to greater innovation within the ETF market with a broad range of product types including smart-beta indices, strategy and active ETFs now available to investors. <sup>1</sup>Source: IFA, December 2013

### What is an ETF?

An ETF enables investors to track a particular index (or strategy) through a single liquid instrument that can be purchased or sold on a stock exchange. While ETFs display the characteristics of a collective investment scheme (such as lower costs and investment diversification) they also share characteristics of equities given the real time pricing and intra-day trading on exchange and the secondary market.

There are several different types of ETF in the market and in Ireland ETFs are regulated as collective investment schemes and can fall within the ambit of either UCITS or AIFMD. The majority of Irish domiciled ETFs are regulated as UCITS and so the general UCITS rules are applicable to them.

### Trading an ETF

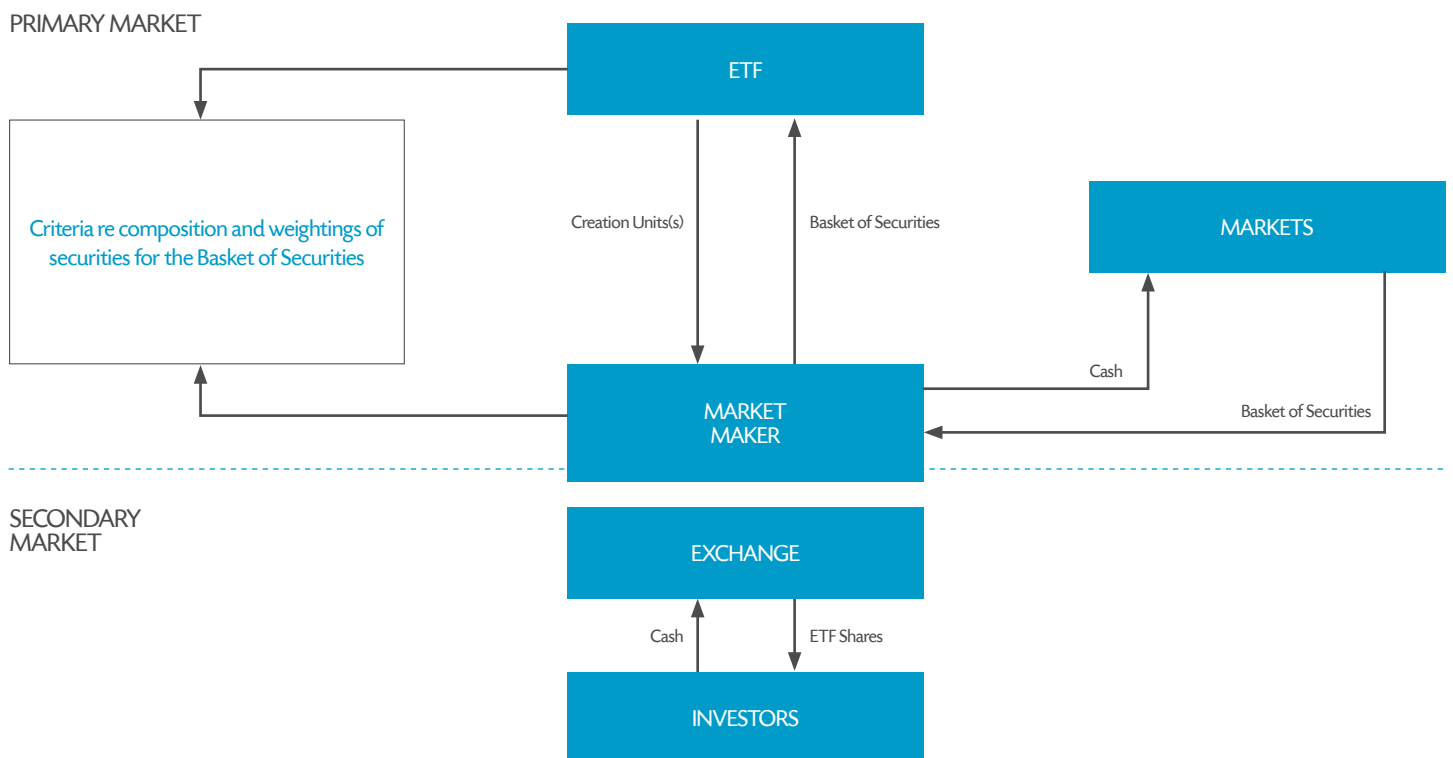
An ETF (unlike a standard collective investment scheme) is structured to enable the shares/units of the ETF to trade on the secondary market. This secondary market trading is facilitated by the use of banks/brokers who effectively act as market makers. With an ETF structure, the market makers will be the only direct shareholders in the ETF (as they acquire the share/units directly from the ETF) with all other investors holding an interest in those shares/units via the secondary market. Please see the diagram below which shows how an ETF operates on the primary and secondary markets.

#### Primary market

The market maker subscribing directly to the ETF for shares/units will become an "Authorised Participant" registered with the ETF's administrator. The shares/units that the Authorised Participant acquires will then be sold by the Authorised Participant on the secondary market.

The issue price of the shares/units acquired by the Authorised Participant corresponds to a pre-established fractional value of the underlying asset that is essentially the "initial issue price" for the shares/units. In some instances, the ETF will allow "in kind" dealing whereby the Authorised Participant pays for the shares/units "in kind" by the delivery of a basket of securities which closely mirrors the composition and weighting of the

### TRADING AN ETF



securities within the relevant underlying index, portfolio or strategy. It should be noted that, whereas the offering document relating to many ETFs will facilitate in-kind dealing, the majority of providers will also provide for cash dealing, specifically in the case of a synthetic ETF.

### Secondary market

The ETF shares/units acquired by the Authorised Participant will be listed on an exchange (such as the London Stock Exchange) where they can be freely purchased and sold, with the settlement being facilitated through recognised clearing and settlement systems.

The price of ETF shares/units traded on the secondary market will be determined by the market and not by the ETF provider and will be in line with the value of its underlying assets (i.e. the financial index, portfolio or strategy) subject to taking account of any tracking error. Generally an indicative net asset value (an iNAV) is issued by or on behalf of the ETF at regular periods intra-day. The purpose of this iNAV is to ensure that those market makers or Authorised Participants sell the shares/units of the ETF on the secondary market at bid/offer spreads that are within a few basis points of the most recent iNAV. It is in the interest of the ETF provider and the investor that the bid/offer spread is kept as tight as possible however it may be more beneficial to an Authorised Participant to quote at a broader bid/offer spread as the spread ultimately allows the Authorised Participant to cover the risk of buying/redeeming shares/units in the primary market at a price that is different to the price the shares/units are sold/bought on the secondary market.

### Physical v. Synthetic ETFs

A distinction often made with regard to ETFs is whether they are structured as “synthetic” or “physical” ETFs.

#### Physical ETFs

A “physical” ETF simply owns the securities of an underlying asset (let’s assume for the purposes of this example that the underlying asset is a financial index, the CAC 40). A physical ETF tracking the CAC 40 would simply hold shares of all 40 companies listed in this financial index in the same percentages and concentrations as the financial index (subject to compliance with the diversification limits applicable to UCITS and financial indices). The main advantage to the physical ETF model is that there is no counterparty risk, however securities lending forms a large part of the physical ETF’s operating model and so it would not be correct to say that the product is less risky per se.

#### Synthetic ETFs

A “synthetic” ETF more often than not invests in total return swaps (financial derivatives) where a counterparty pays the exact return of the relevant underlying asset. Such products can provide better returns since they allow a provider to reduce the cost and tracking errors vis-à-vis the relevant underlying asset compared to a physical ETF but they do entail counterparty risk (albeit that such risk can be minimised through the utilisation of collateral).

Some ETF providers choose to have a combination of physical and synthetic ETFs in their product offering and in some instances an ETF may be structured in order to follow either approach depending on market conditions. As a general rule, the synthetic approach in some shape or form tends to work better where you have a less liquid underlying asset, for example an emerging or frontier market index, a hedge fund index or a trading strategy or portfolio of assets. Under the terms of the ESMA Guidelines, ETF providers are obliged to clearly label their ETF so that investors understand whether the ETF is physical or synthetic and the relevant attendant risks.

### Passive v. Active ETFs

#### Passive ETFs

ETFs were originally constructed to operate as a single security that tracks a financial index and trades on an intraday basis. This form of trading enables investors to buy and sell, in essence, all of the securities that make up an entire market (such as the S&P 500 or the CAC 40 as per the previous example) with a single trade.

The main difference between passive ETFs and other types of index funds is that passive ETFs do not seek to outperform their corresponding financial index, but simply replicate its performance. In other words, passive ETFs do not seek to beat the market, they try to be the market. Passive ETFs combine the range of a diversified portfolio with the simplicity of trading a single stock. The purpose of a passive ETF is to match the performance of a particular financial index. In the case of a passive ETF, the investment manager adopts a “passive” approach and makes only minor, periodic adjustments to keep the ETF in line with its underlying financial index (and in the case of an ETF regulated under UCITS, in line with the UCITS diversification requirements). This is quite different from an actively managed fund, where the manager continually trades assets in an effort to outperform the market. Because they are tied to a particular index, passive ETFs tend to cover a discrete number of stocks, as opposed to a fund whose scope of investment is subject to continual change. For these reasons, passive ETFs mitigate the element of “managerial risk”. Rather than investing in a fund manager, when you buy shares of a passive ETF you are harnessing the power of the market itself. By eliminating the need for active management, passive ETFs tend to be lower cost, and because they generally change the composition of their portfolio less frequently than an actively managed fund or an active ETF, transaction costs may be lower.

#### Active ETFs

While passive ETFs are structured to track or replicate the performance of a financial index, they could just as easily be designed to track a popular investment manager’s top picks, mirror any existing mutual fund or pursue a particular investment objective. Aside from how they are traded, these “active” ETFs can provide investors/traders with an investment that aims to deliver above-average returns. While there are not as many active ETFs as there are actively managed funds or passive ETFs, they are growing in popularity particularly in the United States.

Active ETFs have the potential to benefit both fund investors and fund managers. If an active ETF is designed to mirror a particular fund, the intra-day trading capability will encourage frequent traders to use the active ETF instead of the fund, which will reduce cash flow in and out of the fund, making the portfolio easier to manage and more cost effective, enhancing the mutual fund’s value for its investors.

Because active ETFs trade on exchange, there is the potential for price disparities to develop between the trading price of the active ETF shares/units and the trading price of the underlying securities of the active ETF. This creates the opportunity for arbitrage. If an active ETF is trading at a value lower than the value of the underlying securities, investors can profit from that discount by buying shares of the active ETF and then cashing them in for in-kind distributions of shares of the underlying stock. If the active ETF is trading at a premium to the value of the underlying shares, investors can short the ETF and purchase shares of stock on the open market to cover the position.

With passive ETFs, arbitrage keeps the price of the passive ETF close to the value of the underlying financial index. This works because everyone knows the holdings in a given financial index. The passive ETF has nothing to fear by disclosing the holdings, and price parity serves

everyone's best interests. The situation would be somewhat different for an active ETF, whose manager would get paid for stock selection. Ideally, those selections are to help investors outperform their ETF's benchmark index. If the active ETF disclosed its holdings frequently enough so that arbitrage could take place, there would be no reason to buy the ETF: smart investors would simply let the fund manager do all of the research and then wait for the disclosure of his or her best ideas. The investors would then buy the underlying securities and avoid paying the fund's management expenses. Therefore, such a scenario provides no incentive for money managers to create actively-managed ETFs. This risk can be mitigated through issuing information relating to the portfolio of the active ETF on a time delayed basis.

**Note:** Whilst most ETFs (passive or active, physical or synthetic) are structured to provide a return linked to a financial index, an ETF may legitimately deliver a return based on another diversified asset such as a portfolio of assets or a strategy. The challenge that presents itself is the ability to provide a sufficient degree of transparency and liquidity with regard to that portfolio or strategy and for a synthetic product, it may prove challenging to source a counterparty willing to write a swap where the underlying asset is a portfolio or strategy.

### Listing ETFs in Ireland

An ETF structured as a UCITS can seek access to trading on the main market of the London Stock Exchange (LSE) in a cost efficient manner by listing on the Irish Stock Exchange (ISE) without the need for the fund to also be admitted to the Official List of London. The ISE is an EEA competent authority for the purpose of the LSE's admission process.

The admission process in the UK is made up of two stages; listing and admission to trading. The ISE listing satisfies the first part of this within a very reasonable timescale and with significant cost and administrative savings as there are none of the additional requirements associated with a full LSE listing. The ISE has a streamlined listing process for the listing of UCITS and the document review can occur at the same time as the authorisation by the Central Bank of Ireland to ensure approval is obtained in a time efficient manner.

There is no requirement to appoint a UK listing sponsor nor is there a listing process with the UK Listing Authority (UKLA).

ETF issuers can apply to admit ISE listed ETFs to the LSE's main market by submitting the following documentation to the LSE:

- a copy of the listing particulars, approved by the ISE;
- a certificate of UCITS compliance;
- a copy of the approved prospectus/pricing supplement, stamped by the ISE;
- evidence of Financial Conduct Authority (FCA) recognition status, and
- a completed London Stock Exchange Form 1 and Static Data Form.

The benefits of being listed on the ISE and admitted to trading on the LSE are as follows:

- Cost efficient. A single fund or sub-fund may be listed in Ireland for less than €5,000 which includes the annual fee for the first year of listing.
- Speed to market. The ISE have a streamlined process for the listing of UCITS making it possible to achieve a listing within in a very short period of time.
- Documentation. A single document can be used for Central Bank approval, ISE listing and LSE admission to trading.

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