

Ireland Fund Services

IN FOCUS 2020



 [etfexpress](#)  [hedgeweek](#)  [institutionalassetmanager](#)

 [privateequitywire](#)  [propertyfundsworld](#)  [wealthadviser](#)

PRIVATE FUNDS

Refreshed legislation encourages growth

INTERNATIONAL PROVIDERS

Offering clients a consistent experience across jurisdictions

NON-TRANSPARENT ETFs

Gathering pace for European vehicles as diversity builds

Featuring CSC | Dillon Eustace | Irish Funds | Simmons & Simmons

Is the case for European “non-transparent” active exchange traded funds gathering pace?

By Shane Coveney

As European exchange traded products gather a greater share of asset flows and surpass USD1 trillion in assets under management, the industry's appetite for new and innovative products continues to develop at a greater pace than ever. Historically, fragmentation in the European market has been a significant obstacle, leading to slow growth in the exchange traded fund (ETF) market in Europe. However, market commentators predict a significant growth in the ETF industry in Europe in the coming years, with predictions of the industry growing to USD2 trillion in assets under management by 2024. With such growth and a large number of new entrants coming to Europe, we anticipate the development of more diverse and innovative products over the coming years. Ireland, as the leading domicile for European ETFs, will play a large part in the future development of the regulated ETF product.

European ETFs are typically established as undertakings for collective investment in transferable securities (UCITS) pursuant to the UCITS Directive and as such have a number of specificities which are unique to the UCITS ETF product. UCITS are investment funds established and authorised under a harmonised EU legal framework under which a UCITS established and authorised in one EU Member State can be sold cross border into other EU Member States without the requirement for any additional authorisation.

In recent times, observers of the European ETF market will have noticed the growing trend to launch pure play thematic ETFs, ranging from computing and robotics to healthcare and cannabis, and products with a focus on environmental, social and governance (ESG) aspects. However, to date, there has been little development in Europe in seeking to bring “non-transparent” active products to market when compared to the US ETF industry.

Non-transparent prospects

“Non-transparent” active products are actively managed ETFs that do not provide the market with full

transparency in relation to the holdings, or the relevant weightings, of the investment fund on a daily basis. This lack of development can, in large part, be put down to the regulatory framework in which European ETFs are established that sees ETFs regulated as UCITS products, and the fragmented listing requirements which differ slightly in a number of jurisdictions.

Should an ETF Issuer aim to enter the European market by seeking to adapt one of the many mechanisms approved in North America for the European market, the key issues which will need to be overcome include having the ability to illustrate how the intra-day net asset value (iNAV) would be constructed and verified as well as implications for the timing of exchange trading; the different possible approaches to creations / redemptions where the portfolio is not disclosed; and the extent to which an ETF Issuer would ensure public disclosure of the underlying assets.

The Central Bank of Ireland (the Central Bank), as a leading regulatory authority in Europe, outlined in its “Feedback Statement on DP6 – Exchange Traded Funds”, published in September 2018, its position on the requirement for Irish ETFs to provide daily portfolio disclosure in the context of the authorisation of ETFs as investment funds. The Central Bank has previously stated that a key element of ETFs is transparency and portfolio disclosure. The Central Bank has been clear on its position, stating in its guidance that it “will not authorise an ETF, including an active ETF, unless arrangements are put in place to ensure information is provided on a daily basis regarding the identities and quantities of portfolio holdings”. It also requires that the offering documentation “disclose the policy regarding portfolio transparency including where information on the portfolio may be obtained”. In this regard, the Central Bank advocates transparency and portfolio disclosure to be seen as an effective tool which seeks to ensure effective arbitrage and as being integral in seeking to ensure efficient and liquid markets exist where spreads on the secondary market can be kept as narrow as possible.

It has been argued in the past that transparency is

a cornerstone of the European ETF industry, however, this is not a view which is shared by all market participants, particularly those seeking to establish a “non-transparent” active product, who have identified this issue as a stumbling block to the development of the ‘active ETF’ product. In response to this assertion, many market participants have advocated solutions whereby full portfolio disclosure is provided to a restricted group of recipients including regulators, stock exchanges and, where bound by confidentiality, Authorised Participants, or with the publication of the actual constituents of the ETF without providing the actual weightings of each constituent or, finally, the use of a ‘proxy basket’. Such solutions have been accepted by the US Securities and Exchange Commission and may meet the requirements of the Central Bank. However, such solutions have not been examined in depth through an application to the Central Bank as yet. Should this issue be satisfied to a regulators satisfaction, as ever, the fragmentation in the listing requirements in different jurisdictions will remain a point of contention and is a matter which would also need to be addressed contemporaneously.

Additional complexity

The more complex issue to be addressed in a submission which would be required to bring the first European “non-transparent” active ETF to market would be the method by which an iNAV could be disseminated to market makers in real time to facilitate active trading on the secondary market. Market participants will argue that providing disclosure to a sub-set of market participants or providing an indicative creation basket on a daily basis could be the most appropriate solution to this conundrum. Both would permit the relevant market markets to generate real time iNAVs, and assist in the creation / redemption process in the primary market – however such proposals have not, as yet, received regulatory approval in Europe.

As ETF Issuers continue to strive to bring new products to market it will be interesting to examine the development in the “non-transparent” active product market. The “non-transparent” active product is expected to see a number of ‘traditional’ asset managers looking to enter the European ETF space. However, any potential new entrants will be keen to learn from the evolution of the



US “non-transparent” active market and the performance of the US “non-transparent” active product will come into sharp focus of potential investors in examining the success of the strategy.

Ireland continues to be at the vanguard of developments in the European ETF industry. The broad range of experienced professionals operating within the European ETF ecosystem in Ireland means that Ireland will continue to be the jurisdiction of choice for many entering the European market. However, it remains to be seen how a regulatory authority would view an application for the authorisation of a “non-transparent” active ETF – the door is not closed but it will take greater investor demand to drive any future development in Europe. ■

Shane Coveney

Partner, Asset Management and Investment Funds Team,
Dillon Eustace



Shane is a partner in Dillon Eustace Asset Management and Investment funds team with particular expertise in exchange traded funds, UCITS and Alternative Investment Funds. Shane has over 10 years' experience in advising international asset management firms and investment banks in relation to structuring, establishing and authorisation of Irish regulated investment funds and in providing regulatory advice to leading asset managers and fund promoters. In addition to advising the promoters and investment managers of such funds, Shane advises fund investors, fund directors and fund service providers on relevant Irish law, regulation and market practice.

Structuring the deal – private equity’s Irish solutions

By Derbhil O’Riordan

Consistently heralded by industry as a flexible and efficient place to do business, Ireland is Europe’s leading onshore jurisdiction for the establishment of private equity structures.

The jurisdiction offers a number of structuring options, including the revised Investment Limited Partnership¹ (ILP) structure which will stand alongside the Irish Collective Asset-management Vehicle as a dynamic structure specifically geared to the private equity market.

Private equity funds are established and regulated in Ireland as Qualifying Investor Alternative Investment Funds (QIAIF) pursuant to AIFMD². Assuming the appointment of a suitable manager (AIFM) and certain regulatory conditions are met, these funds benefit from a passport issued to their AIFM to freely market the QIAIF to professional investors³ in both its own member state and other EU member states. This thereby makes them an attractive vehicle for asset managers looking to raise capital in Europe. As at June 2020, over 2,700 QIAIFs were established in Ireland.

Notwithstanding the ongoing harmonisation of EU laws, including on how private equity structures are managed and marketed, as well as more granular regulation on liquidity management and management of ESG factors, consistent open dialogue between the Irish financial services sector and the Irish financial regulator (the Central Bank) has led to practical and predictable regulatory environment.

Regulation of the QIAIF

The QIAIF regulatory regime is the most flexible available in Ireland and is designed for sophisticated and professional investors. Although they are fully regulated structures⁴, QIAIFs are subject to minimal investment restrictions and have no borrowing or leverage restrictions. QIAIFs cannot guarantee the obligations of third parties, but certain exemptions and flexibilities are available for wholly owned subsidiaries of the QIAIF.

QIAIFs benefit from a fast-track authorisation process at the Central Bank which facilitates a quicker route to market for these products. A QIAIF must appoint an AIFM⁵ who will be responsible for the day to day management and distribution of the ICAV, a depositary responsible for

the safekeeping and oversight of the ICAV’s assets, an investment manager (which function could be carried out by the AIFM or delegated to a regulated investment manager, including the promoter of the QIAIF), who will perform the investment management function and an administrator, who will carry out ICAV valuation and other investor services. Each of the appointed entities must be regulated in their own right.

End-user perspectives

The QIAIF offers flexibility in structuring and benefits from a sound regulatory environment with a well-trodden path, familiar to blue chip industry participants and their investors. While ILP legislation is awaiting imminent publication, the ICAV is the vehicle of choice for housing private equity structures. The ICAV offers a corporate-type vehicle specifically providing for investment funds, importantly however, the ICAV is predominantly legislated for outside of Irish corporate legislation. Unlike the public limited company in Ireland, the ICAV has no legislative requirement for risk spreading and can be used to house single asset funds.

A huge advantage of the ICAV for US investors is that it will not automatically be considered a corporation for US tax purposes and can elect to ‘check-the-box’. This allows it to be treated as a partnership, or disregarded entity, for US federal tax purposes and more readily facilitate investment by US taxable investors and/or US taxable and tax-exempt investors in a master feeder fund structure.

Another advantage of the ICAV is that the constitutional document, the Instrument of Incorporation, can be amended in most circumstances without shareholder approval⁶. This contrasts very favourably with the Memorandum and Articles of Association of a public limited company which requires the sanction of shareholders even in the case of a small administrative or regulatory change.

The ICAV also offers flexibility in that it can be established as an umbrella structure, allowing multiple sub-funds, with different investment strategies, different investors and different terms, all in the same structure. Therefore, a single ICAV can continue to house an ever-green fund in the same “umbrella” as closed ended and

limited liquidity funds, all using a single board of directors, AIFM, depositary and administrator. Where required, each sub-fund can appoint a different regulated investment manager. The ICAV umbrella also offers flexibility in that financial statements can be published on a sub-fund by sub-fund basis. This allows the investment manager to comply with disclosure obligations to investors invested in a given sub-fund, without the necessity to directly share this information with others.

End of life liquidity options of the QIAIF and liquidity stress testing

The QIAIF also offers optimum flexibility in options on liquidity at the end of life of private equity funds. Directors of closed-ended QIAIFs must specify in their offering documents the duration of the term and investment period of the QIAIF, but may also provide that at the end of life of the Fund, the QIAIF will have the following options:

- Wind up the fund;
- Convert to an ever-green fund; or
- With the approval⁷ of shareholders, extend the closed-ended period of the fund.

Recent legislative changes at EU level (the Guidelines) have imposed obligations on AIFMs to ensure harmonisation of the management of liquidity across all EU structures. Of particular note is the imposition of a requirement for regular⁸ liquidity stress testing (LST). These new rules will apply to the management of closed-ended QIAIFs but permit that the model used for each fund is selected taking into account the frequency of the LST, the fund's redemption policy, investment strategy, portfolio composition, liquidity management tools available to it. It will also consider whether or not the Fund engages in efficient portfolio management techniques.

Conclusion

The QIAIF offers optimum flexibility in a regulated structure, with the Central Bank approving structures with partly paid units and bespoke drawdown mechanisms, flexible investment parameters, use of carried interest and waterfall mechanisms and Irish and non-Irish intermediate vehicles for investment purposes. This flexibility, together with investor familiarity, has contributed to sustained growth in the use of Ireland for private equity and joint venture structures.⁹ ■



1. *The Investment Limited Partnership is nearing the completion of a regulatory overhaul targeted at making Ireland a more attractive domicile for private equity funds in particular.*
2. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32011L0061>
3. *Being investors considered to be professional clients or treated as professional clients on request, within the meaning of Annex II of Directive 2004/39/EC on markets in financial instruments (MiFID).*
4. *Ireland also offers unregulated options for private equity structures, which are not contemplated in this paper.*
5. *Which, subject to certain elements of AIFMD being "switched on" to facilitate third country AIFM passporting, should be EU domiciled unless passporting is not required.*
6. *With the sanction of the depositary.*
7. *For QIAIFs offering redemptions at this stage, votes in favour of an extension must represent 50% of votes cast. For those not offering redemption at this stage, votes in favour must represent 75% of votes cast.*
8. *The Guidelines contemplates annual liquidity stress testing depending on the nature, scale and complexity of a fund.*
9. *Figures released by the Irish Funds Industry Association as at July 2020 show Ireland as the fastest growing of the five largest fund locations in Europe over recent years.*

Derbhil O'Riordan

Partner, Asset Management and Investment Funds Team,
Dillon Eustace



Derbhil is a specialist adviser to the investment fund industry having practiced as a partner in Dillon Eustace in both the Cayman Islands and Ireland. She advises hedge and private equity funds in structuring and operating investment vehicles. Recent deal highlights include property QIAIFs for joint ventures, and multi-tiered cross-jurisdictional private equity loan structures. A frequent contributor to financial services publications, Derbhil is also a member of the Irish Funds Depositary Working Group. She is admitted to practice in the Cayman Islands, Ireland, England and Wales, and Northern Ireland.