Exchange Traded Funds from a Lawyer's Perspective – The Case of Germany

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1. Overview

Exchange traded funds ("**ETFs**") from a lawyer's perspective provide for a myriad of legal and regulatory issues. Each of the member states of the European Economic Area ("**EEA**") and the other countries in Europe have their own distinct regulatory regimes. Although certain EEA legislation was introduced to harmonise aspects of those regimes, it was not done to facilitate the easy establishment of ETFs, since ETFs did not exist at that time in Europe or just started to gain some popularity. Rather, ETFs must use whatever harmonising European legislation they can, albeit subject to modification where that legislation has been implemented in each EEA member state.

1.1 Structure of an ETF

ETFs are undertakings for collective investments (i.e. funds) offering investors the investment performance of a designated index (an "**Index**") by the acquisition of shares or units of the ETF listed and traded on stock exchanges.

ETFs can be structured as open-ended investment companies or as alternative vehicles issuing shares, interest or units. In this article, unless stated otherwise, the interests in an ETF, irrespective of its legal form are referred to as "units".

The legal structure of an ETF usually is as follows: subscription and redemption of a minimum number of units (e.g. having a value of at least Euro 1 million) on an in-kind basis at the level of the ETF (the "**Primary**

Market") are reserved to institutional investors, so-called "**Authorised Participants**". The Authorised Participants are typically large investment banks or brokerage businesses. Authorised Participants will have concluded a participation agreement with the ETF setting out the conditions and procedures which allow the Authorised Participant to subscribe and redeem units of the ETF on an in-kind basis. The participation agreement may also cover issues such as how the Authorised Participant will market the units of the ETF. The Authorised Participants act as whole-sellers of the ETF's units. Those Authorised Participants may also act–as market makers for the distribution of the units of the ETF on various stock exchanges, on which other investors are allowed to buy and sell units in accordance with the rules and regulations of those stock exchanges (the "**Secondary Market**").

One key feature, touched upon above, which distinguishes ETFs from traditional funds, is that the constitutional documents of the ETF provide that its units are created in predetermined multiples of units, the "Creation Units" and that the subscription price of those units is paid in kind (or, depending on regulatory requirements, in a way as near as possible to an in-kind solution) by a basket of component securities of the respective Index plus or minus a balancing cash component reflecting the net asset value of the ETF unit.

Similarly, the units can only be redeemed by the Authorised Participants in predetermined multiples of units, the "Redemption Units", against payment in-kind (or, depending on regulatory requirements, in a way as near as possible to an "in-kind solution") by the ETF of a basket of component securities of the Index plus or minus a balancing cash component reflecting the relevant net asset value.

A key benefit is that the in-kind contribution and redemption of component securities eliminates transaction fees to be borne by the ETF as the portfolio manager does generally not need to buy and sell component securities of the Index within the portfolio of the ETF. Another advantage is that ETFs can then provide an attractive fee structure. Mostly, they do not provide for subscription and redemption fees and provide capped all-in-fees of a maximum of around 50 basis points on the net assets of the ETF. For some ETFs their capped all-in-fees are around 20 basis points.

Price transparency for investors on the Secondary Market is ensured by publication at the stock exchange of the so-called iNAV (indicative intra-day