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LESSONS LEARNED – ETF CONVERSIONS

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Financial industry and investor interest in the exchange-trade fund ("ETF") wrapper for investment strategies continues to grow. As of December 31, 2023, there were 3,243 U.S. ETFs with actively-managed ETFs garnering an increasing share of the ETF market.[i] Growing interest in active strategies since 2021 and the regulatory latitude granted to reorganizations of financial products into ETFs since 2019[ii] have spurred increasing mutual fund to ETF conversions. Further, the May 2023 expiration of patents previously held on ETF share classes of mutual funds has caused rising interest in such share classes by a number of fund managers.[iii] This interest is seen in recent 1940 Act exemptive relief filing activity with the SEC where fund managers are looking at ETF classes for their mutual funds and mutual fund classes for their ETFs.[iv] The following provides an update of the joint Brown Brothers Harriman ("*BBH*") and K&L Gates LLP article, "Making the Switch". In particular, this update focuses on lessons learned on mutual fund to ETF conversions and examines the prospects for broader availability of share class ETFs.

Lessons Learned from ETF Conversions:

- All conversions to date are done as **mutual fund series mergers into new ETF series of the same trust or a new trust with the same board**. This transaction structuring allows the ETF to be the survivor of the merger, has no tax effect on shareholders and allows continuity of fund performance history. Importantly, this structuring avoids a need for shareholder voting on the reorganization itself under SEC regulations.
- Typically, the fund manager's fee arrangement undergoes changes in the conversion. **Shareholder votes are not required for such conversions** as long as management fees and administrative expenses remain the same or are lower. As experience has been gained with these transactions, the SEC has taken the position that merely adopting a unitary fee structure for the ETF where the mutual fund was charged an advisory fee separate from other fund expenses does not require shareholder vote.
- While the merger transaction itself is tax-free, **portfolio transition issues need to be carefully plotted to minimize tax and portfolio effects of conversion**. In the easiest transactions, the surviving ETF inherits the mutual fund portfolio and uses the in-kind creation and redemption process to realign the portfolio for ETF needs to negate or minimize tax impact. Otherwise, transitioning the fund portfolio to an ETF setting without using an in-kind creation and redemption process may cause recognition of taxable gains and portfolio brokerage costs that may cause a drag on performance. Some of the easiest conversions from the portfolio transition

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perspective involve strategies reliant on derivatives since the transition can be facilitated as a cash transfer.

- Advisors to multi-class funds are finding that **if a change in transfer agent is a part of the conversion process, the advisor will play a role in the oversight of calculations related to the transition**. These calculations provide the basis for stock splits used to rationalize mutual fund share values across multiple classes in order to provide DTC with ETF delivery instructions at conversion.

The SEC's Role

The SEC is scrutinizing these transactions. An SEC examination priority focuses on the procedures and considerations for the adoption of Rule 12b-1 distribution sales load plans for the ETF where one or more mutual fund classes had no such rule 12b-1 plan in effect before the conversion. This scrutiny is being applied even though each ETF rule 12b-1 plan is dormant and subject to further board approval before implementation. The SEC's stance derives from no shareholder vote occurring to approve the ETF's plan and causes a high degree of scrutiny on board decisions in approving such plans.

SEC guidance is driving the timing of mutual fund class consolidation and suspension of sales loads driven in the conversion registration process. The result is that converting mutual funds suspend their 12b-1 plans and consolidate classes at the earliest moment in the process. A fallout effect of this timing has been fund advisors picking up trailing 12b-1 payments owed to distribution intermediaries from the plan suspension date through the conversion date.

Prospects for ETF Share Classes:

Vanguard's last patent on the mutual fund ETF share class structure expired May 16, 2023. Vanguard utilized this structure from when it gained SEC exemptive relief permitting it originally in 2000.[v] Vanguard mainly used the structure with passively-managed, index-based funds where the management fees for the mutual fund was already low.

Benefits

ETF share classes offer a variety of benefits to mutual fund managers. These benefits principally center on providing various types of investors (*i.e.,* individual, institutional, insurance and retirement investors) with flexibility and choices within a single fund product. Many types of self-directed retirement plans, for instance, are not administratively equipped to allow ETF share trading and only allow mutual fund investments that settle once per day. Fund managers considering their shareholder base cannot assume that all shareholders want to be in an ETF wrapper. Share classes enable a wrapper agnostic offering to suit the needs of different investors.

Importantly, an ETF share class has the ability, for most strategies, to permit benefits of the ETF wrapper to improve tax and cost exposures of mutual fund shareholders. Significant adverse tax consequences and transactional costs typically impact mutual funds, which almost always sell and redeem their shares for cash – requiring portfolio actions to provide, or invest, cash. However, most ETFs pursuing the same mutual fund strategy can engage in in-kind creation and redemption transactions to manage the tax

effects of the portfolio, such as redeeming out portfolio positions with low tax basis that would have a taxable gain if they were sold. This ETF tax efficiency results from the tax-free treatment offered in-kind transactions where ETF shares are exchanged for portfolio positions in-kind. Since ETFs are not completely exempt from the possibility of capital gains, there is also the potential to harvest capital losses through cash trades in mutual fund share classes to benefit the ETF. Additionally, the ability to optimize the daily ETF creation/redemption basket to a larger portfolio of securities (that is supplemented by non-ETF cashflow) can help promote liquidity of the ETF.

Significant benefits may accrue to the fund manager with ETF share classes related to the utilization of a new fund share distribution channel and strategy integrity:

- ETF class launches can occur immediately with the ETF having an existing performance track record and a viable asset base presented by the mutual fund portfolio, provided at a lower cost than launching a standalone ETF.
- Unlike a mutual fund conversion into an ETF, there would be no need for the types of transactional delays caused by a merger reorganization.
- Finally, ETF share classes enable the fund manager to avoid cannibalizing an existing fund with a separate ETF using same strategy and investor or financial advisor objections to investing in cloned or "diluted" strategies in a separate ETF.

Concerns

The ability to use an ETF share class has a number of impediments and concerns with ultimate approval. The primary impediment centers on the need to procure SEC exemptive relief where the SEC staff is overloaded with other regulatory priorities.

While the SEC has previously acknowledged that it is interested in "leveling the playing field" so that more industry participants would have the ability to operate ETF share classes, the SEC and its staff have articulated a number of issues it needs addressed before granting further ETF share class relief. In particular, the SEC wants assurance that the ETF share class is not being subsidized by mutual fund classes and vice versa.

The basic SEC focus seems to center on a need for the entire fund structure to be fundamentally fair to all share classes and the structure polices itself for this result.

One concern is the potential for unexpected redemptions of mutual fund shares requiring portfolio position sales causing negative tax effects to remaining ETF class shareholders. The SEC is also mindful of ensuring that higher fund operating expenses of the mutual fund classes are not subsidizing lower ETF class expenses.

Additional operational concerns include:

- Fund managers will need to address cash drag on performance due to mutual fund redemption liquidity needs where an in-kind ETF has no such liquidity needs.
- An ETF share class may not be suitable for all mutual fund strategies. The fund's strategy must be scalable since the ETF cannot close itself to new investment. In addition, the fund's portfolio holdings must be sufficiently liquid so that the ETF's interaction with the capital markets is

efficient enough to maintain low ETF share bid/ask spread and minimize and premium/discount condition between ETF share NAV and trading prices.

- Just as with any new ETF, a new ETF share class needs to be launched with an understanding of the fund's position in the capital markets ecosystem and ETF share distribution dynamics in order to fully benefit from the ETF wrapper.

Addressing SEC concerns will require fund managers to properly allocate fund costs and tax effects to each specific class (*i.e.,* gains on sales due to redemptions, brokerage costs and class specific fees such as ETF exchange listing fees). Many industry participants believe that fund administrators can address most of this concern through automation that will systematically allocate the tax and cost effects to appropriate share classes.

Finally, the launch of an ETF share class, while providing investors with greater flexibility and choices in a single fund product, may create investor confusion. Such confusion would center on understanding the benefits and costs of mutual fund share classes over ETF share classes. Thus, significant attention would need to be paid to the adequacy of the fund's disclosures.

Next Steps

The ETF industry has experienced unprecedented growth over the past decade, while emerging categories (actively managed ETFs) present an opportunity for new entrants into the space. Traditional fund and SMA managers now have multiple paths to enter the ETF space that preserve the established scale and track record of existing structures while removing potential distribution barriers posed for new products. However, it is important to weigh the legal, commercial, and operational considerations involved with the product structuring decision. (Connect with BBH and K&L Gates for more information on product structuring)

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[i] *See* NYSE and trackinsight's joint website, ETF Central, "ETF Industry KPIs – 11/6/23" by ETF Think Tank (https://www.etfcentral.com/etf-u/news/this-week-the-industry-experienced-14-etf-launches).

[ii] Rule 6c-11 (the "*ETF Rule*") promulgated under the Investment Company Act of 1940 ("*1940 Act*"). Rule 6c-11(a)(2) provides: "Notwithstanding the definition of exchange-traded fund . . . of this section, an exchange-traded fund is not prohibited from selling (or redeeming) individual shares on the day of consummation of a reorganization, merger, conversion or liquidation, and is not limited to transactions with authorized participants under these circumstances."

[iii] *See* Final Rule Adopting Release, SEC Nos. 33-10695 & IC-33646, "Exchange-Traded Funds" at 121-125 (Sept. 25, 2019) (https://www.sec.gov/rules/2019/09/exchange-traded-funds#33-10695). The ETF Rule's adopting release noted that the rule did not provide regulatory relief to permit share class ETFs, although the SEC expressed an interest in leveling the playing field once share class policy considerations were adequately addressed through the SEC's exemptive relief application and order process.

[iv] *See, for example,* Perpetual US Services, LLC, Application for Exemptive Relief (Feb. 8, 2023) (https://www.sec.gov/Archives/edgar/data/1965046/000121390023009034/s149241_40app.htm); and Dimensional Fund Advisors LP, *et al.*, Application for Exemptive Relief (July 12, 2023) (https://www.sec.gov/Archives/edgar/data/355437/000168035923000216/dimensional40app07122023.htm) (ETF class of a mutual fund); and F/m Investment LLC, *et al.*, Application for Exemptive Relief (Aug. 22, 2023) (https://www.sec.gov/Archives/edgar/data/831114/000089418923006022/rbb-fm_40-app.htm) (Mutual fund class of an ETF).

[v] See Vanguard Index Funds, Rel. Nos. IC-24680 (Oct. 6, 2000) (notice) and IC-24789 (Dec. 12, 2000) (order); Vanguard Index Funds, Rel. Nos. IC-26282 (Dec. 2, 2003) (notice) and IC-26317 (Dec. 29, 2003) (order); Vanguard International Equity Index Funds, Rel. Nos. IC-26246 (Nov. 3, 2003) (notice) and IC-26281 (Dec. 1, 2003) (order); Vanguard Bond Index Funds, Rel. Nos. IC-27750 (Mar. 9, 2007) (notice) and IC-27773 (Apr. 25, 2007) (order).