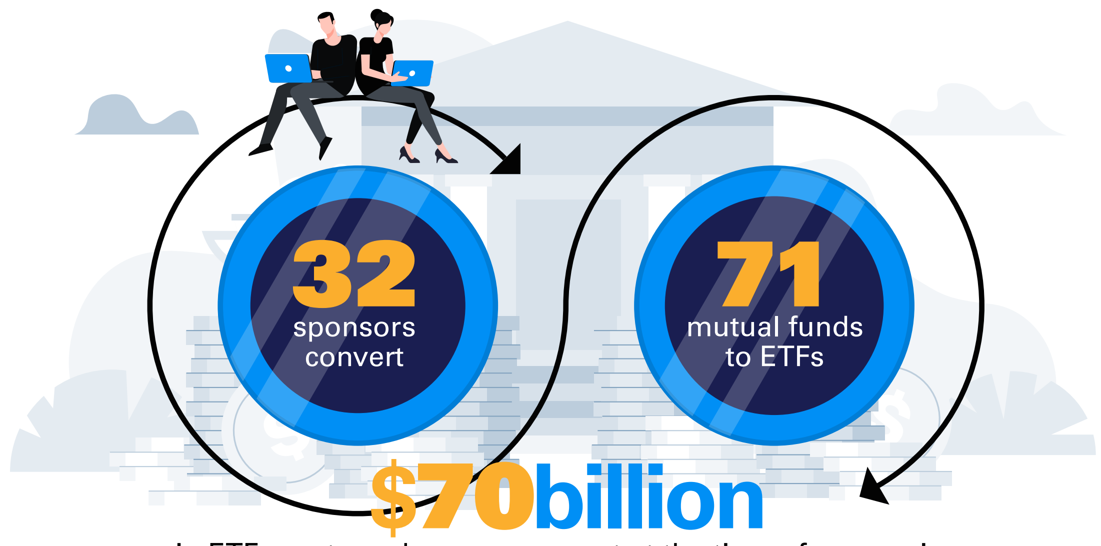
K&L GATES | BROWN BROTHERS HARRIMAN

Mutual Fund to ETF Conversion

Since the first conversion was executed by Guinness Atkinson in 2021, a number of issuers have followed suit. Since 2021, 32 sponsors have converted 71 mutual funds to ETFs, representing $70 billion in ETF AUM at the time of conversion. For a more detailed look at the landscape, read the latest paper from K&L Gates and BBH.



in ETF assets under management at the time of conversion

State of Play: Mutual Fund to ETF Conversions

As more investors select and utilize an expanding ETF toolkit, many managers are responding with new and innovative products, including converting their existing mutual funds into ETFs.

The Conversion Landscape

It's only been two years since mutual fund-to-ETF conversions first came on the scene, but they've made an impact in their short history. The benefits of conversions have largely endured.

Big Developments:

- March 2021 BBH supports first MF to ETF conversion for Guinness Atkinson
- June 2021 – Dimensional Fund Advisors - $30 billion
- Jan 2022 – JPMorgan - $8.7 billion

MUTUAL FUND TO ETF CONVERSIONS: WHAT WE'VE LEARNED

Why it works:

- A way to enter the expanding ETF market with a proven track record
- Avoids conflict of cloned strategies with distribution partners
- May help control operating cost for the manager
- More tax efficient structure/tax benefits
- Most conversions have not required a proxy vote (as shareholder fees and expenses have remained equal to or lower than the mutual fund)
- Conversions have largely not been considered a taxable event

Considerations:

- Appropriately informing shareholders and securing brokerage access can be a lengthy process
- Operationally complex with a need for precise timing on the suspension of sales loads, brokerage notification, and portfolio conversion to minimize tax and portfolio effects
- Negative tax implications for certain holdings markets outside the U.S. (for example, India)
- Fund board decisions on fee plans under regulatory scrutiny

The Next Phase: Share Classes?

The long-standing Vanguard patent on mutual fund ETF share class structure – used mainly with passively managed, index based funds – expired in May. While firms have filed to take advantage of this structure, the prospect of SEC approval in the near future remains uncertain.

Big Developments:

- February 2023 – Perpetual U.S. Services files for the first ETF share class of mutual funds with SEC
- May 2023 – Vanguard patent on mutual fund ETF share class structure expires
- July 2023 – Dimensional files for exemptive relief for ETF share classes

THE NEXT PHASE: SHARE CLASSES?

Why it works:

- Offer shareholder flexibility and choice with a single product
- ETF class launches with existing track record & viable asset base presented by mutual fund portfolio
- Avoids cannibalizing existing fund with separate ETF using same strategy
- Permits tax benefits of ETF wrapper to improve tax and cost exposure of mutual fund shareholders
- Supports the liquidity of the ETF through an optimized holdings basket

Considerations:

- Must demonstrate that ETF share class is not being subsidized by mutual fund classes & that unexpected redemptions of mutual fund shares requiring portfolio position sales will not cause negative tax effects to ETF class shareholders
- Cash drag on performance due to mutual fund redemption liquidity needs
- Need an understanding of fund's position in capital markets ecosystem and ETF distribution dynamics

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