Brown Brothers Harriman

EXCHANGE THOUGHTS

BBH's ETF NEWSLETTER

Making the Switch

New Impetus for Turning a Mutual Fund into an Exchange-Traded Fund

in partnership with

K&L GATES

Welcome to EXCHANGE THOUGHTS

BBH's ETF Newsletter

Now in its second edition, this guide by BBH and K&L Gates assesses regulatory, business, and operational considerations for converting a mutual fund to an ETF and presents a case study of a recent switch.

In a seemingly annual occurrence, in 2021 the global exchange-traded fund (ETF) market has set a new record for growth. Assets increased 24.8% year-to-date, going from US$7.99 trillion at end of 2020, to US$9.98 trillion, according to data released by independent research and consultancy firm ETFGI. The popularity of ETFs across a wide range of investors shows no signs of abating and this demand continues to create a strategic priority for asset managers to have a viable product offering.

While managers continue their march into the ETF market, those with existing ETF product lineups are doubling down on the structure and creating new, innovative investment strategies in the product wrapper. Asset managers have long had a few paths to creating and scaling their ETF business, either organically building their own ETF business, acquiring an existing ETF issuer, and even 'renting' ETFs via a turnkey platform. In the U.S. market, 2021 marked a new option for managers: converting an established open-end mutual fund to an ETF.

March 2021 saw Guinness Atkinson convert two open-end mutual funds into ETFs, the first conversion of its kind in the U.S. This was followed by subsequent conversions by Adaptive Investments, Dimensional Fund Advisors and Foothill Capital Management with year-to-date converted AUM of over US$37 billion. What had been a point of intellectual curiosity for many firms is now shaping up as a strategic priority with several benefits (see Figure 1) and firms appear to be planning more conversions for 2022. The broad appetite of ETF investors for passive and active strategies, broad-based index exposure and mega-trend adoption, high yield portfolios and semi-transparent structures coupled with the ability to retain existing assets and performance track record via a conversion is driving many managers to formulate plans to make the switch.

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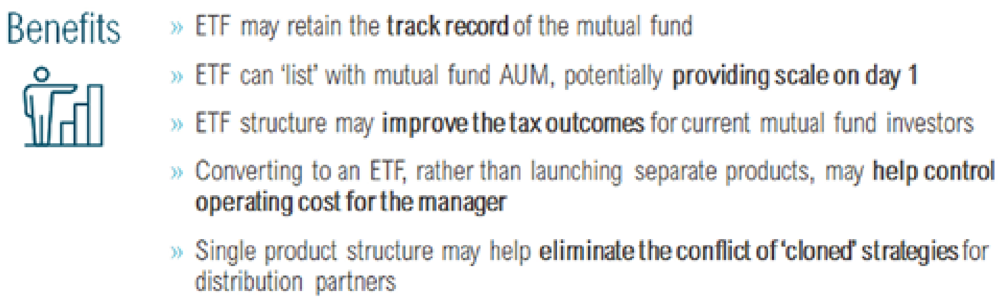
In 2019, to assist fund managers who were considering reorganizing existing mutual funds into ETFs, BBH partnered with K&L Gates to publish a guide, titled *Turning a Mutual Fund into an Exchange-Traded Fund*. The guide discussed some of the regulatory, business and operational considerations for converting a mutual fund into an ETF. In this updated version of the guide, BBH and K&L Gates reunite to take stock of latest developments impacting those conversions and share their experience in connection with recent client conversions.

Figure 1: Benefits of converting a mutual fund to an ETF:



Source: BBH

Conversion Benefits

It should be understood that converting a mutual fund into an ETF will be an extensive project for any firm. As Guinness Atkinson Co-Founder Jim Atkinson has said, the conversion "touched every aspect of our business."[2] With a blueprint now available, however, and the SEC's willingness to not stand in the way of such transactions, the benefits of converting an existing mutual fund to an ETF structure may outweigh the costs for many managers.

While the growth of the ETF market appears to be accelerating, it remains a highly competitive and concentrated market. As products proliferate, attracting assets and distributing ETFs is only getting more difficult. The ability for managers to retain their mutual fund investors and assets in the ETF conversion is one of the largest benefits for funds and fund managers considering a conversion. The opportunity to create instant scale in an ETF product, defraying operating costs, eliminating the need to secure and tie up seed capital, and potentially overcoming minimum assets under management requirements from distribution partners may be more impactful to many managers than launching a new product or starting an ETF suite from scratch.

For active managers, the ETF market continues to present opportunity. Demand for fixed income ETFs and the options to now offer ETFs that limit portfolio transparency has given managers even more options when bringing ETFs to market. However, as BBH's Annual Global ETF Investor Survey[3] shows, ETFs are not immune to investors' desire for historic performance and many intermediary platforms will also have minimum track-record requirements that must be satisfied before adding active ETFs to their platforms. Conversion of a mutual fund into an ETF generally will allow for the track record of the mutual fund to be retained and continued by the ETF, presenting another powerful benefit, especially for active managers.

Finally, by converting to an ETF, managers may also remove another potential sticking point with their intermediary partners: cloned investment products. Launching a new ETF with the same or substantially similar strategy in a mutual fund or other product already used by a firm's intermediary partner may face a lengthy timeline to gain access on those platforms, or risk seeing the mutual fund being removed in favor of a lower cost ETF. Converting such mutual funds to ETFs may help managers remove the issue of clones from their intermediary discussions, while offering a generally more tax efficient vehicle for the financial advisors and investors on those platforms.

[2] https://citywireusa.com/professional-buyer/news/we-now-know-we-can-do-it-guinn ess-atkinson-ceo-bets-on-more-etf-conversions/a1522752

[3] BBH's Annual Global ETF Investor Survey 2021

The altered regulatory landscape

For years, the SEC had been unwilling to permit the reorganization of a mutual fund into an ETF. Prior to the adoption of Rule 6c-11 (the ETF Rule), all sponsors of ETFs were required to obtain exemptive relief in order to sponsor and issue ETFs.[4] All ETF exemptive relief required ETFs to create and redeem ETF shares with authorized participants (APs). In the SEC's ETF Rule adopting release, the SEC noted that ETFs are exempted from the requirement to only transact with APs when there is a reorganization, conversion, or merger. While the SEC no longer has fundamental philosophical objections, the SEC has expressed concern with the fairness to shareholders of any such conversions. This emphasis on fairness will mean a close regulatory focus on the mechanics of the transaction and the shareholder impact.

[4] https://www.govinfo.gov/content/pkg/FR-2019-10-24/pdf/2019-21250.pdf

How to make the switch

Step 1: Assess your client base in the mutual fund

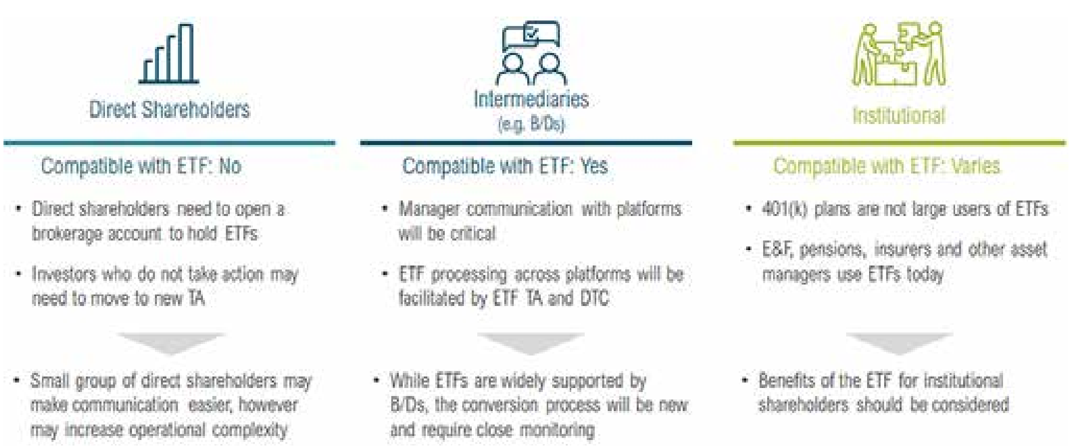
Investors' usage of ETFs will certainly vary between institutions and retail investors. While fund managers need as much of that investor base to remain in the ETF post conversion to maximize the benefit of making the switch, it's important that they identify the types of investors currently holding shares of the mutual fund, their compatibility with ETFs *(see Figure 2)*, the communication requirements and how those investors and intermediaries may feel about owning ETF shares.

Direct Shareholders:

Direct shareholders were long thought to be a sticking point for this type of fund conversion. Mutual fund shareholders may hold their shares directly with the mutual fund on the books of the funds' transfer agent (TA). All ETF shares, in contrast, are held in a book-entry only form through the Depositary Trust & Clearing Corporation (DTCC) and individual shareholders buy and sell ETFs in the secondary market through their brokerage accounts. This feature of ETFs raises a host of considerations managers must account for:

- The ability to communicate any change to shareholders will be critical for the fund manager and likely involve the mutual fund's TA, distributor, and the firm's sales or client service organization;
- Direct shareholders will need to move to a brokerage account (who is a DTCC participant) to receive ETF shares or receive a cash payout for their mutual fund shares;
- Direct shareholders who do not move their mutual fund shares to a broker dealer may be supported by a TA for a period of time; and
- Any cash payout for direct investors may have adverse tax consequences.

Figure 2: Investors in mutual funds and requirements to convert them to ETFs



Source: BBH ETF team

Intermediaries

As mentioned, ETFs are traded between investors in their brokerage accounts and many broker-dealers already support ETFs today. However, managers should have discussions with their intermediary partners early on in this conversion process to confirm those partners can support the timing of the conversion and provide shareholder communications. All such discussions should address the specifics of conversion and be consistent among all partners.

Importantly, managers should also discuss the potential changes in access to the retail investors and advisors that a shift to an ETF structure may precipitate. For example, ETFs and mutual funds typically have differing revenue sharing arrangements, as ETFs do not typically charge investors a 12b-1 fee or sub-TA or sub-accounting fees. Additionally, managers should understand how the platform's due diligence requirements may differ between a mutual fund and an ETF and how a conversion would be viewed by those teams. Operational considerations should also include the platform's ability to support fractional shares in investor accounts. To summarize, managers must:

- Confirm the intermediary is aware of conversion well in advance as well as their ability to support fractional shares in the conversion process
- Understand the intermediaries' process to affect the change and how quickly shareholders will see the change in their accounts
- Confirm how the intermediary reviews newly listed ETFs from a due diligence perspective and what ETF specific requirements they may have
- Confirm how revenue sharing arrangements may change in moving from the mutual fund structure to an ETF (e.g., no 12b-1 fee)

Institutions

Mutual fund managers must assess their institutional client base and potentially engage directly in terms of interest in holding ETF shares. For example, defined contribution retirements plans (e.g., 401(k) plans) are not large users of ETFs as they are tax deferred, do not allow for intra-day trading, and may have other investment products with similar price points to the ETF. Other institutional investors such as hedge funds and insurers may use ETFs, but managers should better understand their objectives and how the products are deployed in their portfolios (e.g. cash management and hedging). Managers should:

- Consider and assess the type of institutional investors in funds today;
- Review 401k plans and other tax deferred investors in mutual fund as asset retention in ETFs may be less likely; and
- Analyze asset management and investment consultant relationships and confirm their ability to use ETFs today.

Step 2: Determine the appropriate regulatory path forward

As mentioned, any manager's goals in a reorganization will include the portability of the mutual fund's performance to the ETF and the continuity of regulated investment company tax treatment. Managers have two paths available to meet these goals, through either: (i) a conversion of the mutual fund into an ETF, or (ii) a reorganization of the mutual fund into a new affiliated ETF via a merger, meeting the requirements of Rule 17a-8 under the Investment Company Act of 1940 (the 1940 Act) *(see Figure 3)*.

In a conversion, there is no transfer of assets and the ETF wrapper replaces the mutual fund wrapper in the existing trust with the same governing board. Such a conversion requires, at a minimum, an amendment to the fund's Form N-1A registration statement, an amendment to the trust agreement to provide for ETF series share creation and redemption methodologies, and an evaluation as to whether a shareholder vote is required or desirable.

Some managers may see the conversion path as optimal as it may reduce some of the timing associated with a fund registration and asset transfer as well as the costs associated with those events. Nevertheless, a direct conversion may require a shareholder vote before such a fundamental change can occur. A proxy vote solicitation effort to drive in the required favorable vote would necessarily be expensive and would be in addition to the costs of registering a new ETF. Any conversion will be governed by the mutual fund's existing operating documents, which can create additional hurdles to the conversion.

Finally, the SEC has a greater opportunity to delay the process in the context of a proxy solicitation through its comment process. The SEC has noted that it has concerns around fairness of a complex transaction, which shareholders may not be able to fully appreciate regardless of the depth of the proxy statement's disclosures, and when some shareholders voting against the conversion will still be dragged into the conversion after the vote. Due to these issues, among others, no direct conversion from a mutual fund to an ETF has been attempted to date.

In a Rule 17a-8 affiliated funds merger, the mutual fund series merges into a new ETF series, either of the same trust or a new affiliated trust. The merger is deemed to be an asset transfer for accounting purposes, which generally allows the historical mutual fund performance to become that of the ETF. If the requirements of Rule 17a-8 are met, the 1940 Act will not require a shareholder vote to accomplish the merger. Further, most standard mutual fund organizational documentation would not separately require a shareholder vote for an affiliated fund merger. Nevertheless, the mutual fund's operating documents should be reviewed verify that a shareholder vote is not required.

An ETF series will register its offering on Form N-1A and the merger will be registered on a Form N-14 containing the mutual fund's information statement (or proxy statement if a vote is otherwise required or desired) and the ETF's prospectus. To date, the conversions that have taken place have all relied on the 17a-8 affiliated funds merger and shareholder votes are not required solely by the merger itself.

Figure 3: Considerations and regulatory requirements for managing fund conversions vs. mergers

	Conversion	Merger 17a-8
Track Record	✓	✓
New Series		✓
N-1A Update	✓	✓
Proxy Vote	potentially	No
Board Approval	✓	✓
Asset Transfer		✓
	Mutual fund becomes an ETF via updated regulatory filings	New ETF structure created, assets are transferred from MF to ETF

Source: BBH ETF team

SEC relief and exchange listing rules

Regardless of the regulatory path, the ETF must comply with appropriate SEC guidelines and rules. As noted above all ETFs need some form of exemptive relief under the 1940 Act to operate. As noted above, the SEC adopted the ETF Rule, which eliminated the need for individual exemptive orders for daily transparent ETFs, and specifically allows for the reorganization of mutual funds into ETFs. However, managers contemplating operating an ETF under a transparency substitute method for which exemptive relief has been received,[5] are not covered by the ETF Rule and will need to procure an exemptive order.

Unlike mutual funds, ETFs must comply with their stock exchange's listing rules. In April 2020, the SEC approved exchange listing rules for the NYSE Arca, CBOE and Nasdaq that largely harmonize the listing rules with the ETF Rule's requirements.[6] Prior to the approval, many traditional ETFs generally enjoyed generic listing standards that permitted their shares to trade on an exchange, however, some ETFs did not qualify for generic listing standards and required bespoke approval from the particular exchange and the SEC.

[5] See In the Matter of Blue Tractor ETF Trust and Blue Tractor Group, LLC, SEC Rel. Nos. IC-33682 (Nov. 14, 2019) (notice) and IC-33710 (Dec. 10, 2019) (order); In the Matter of Fidelity Beach Street Trust, Fidelity Management & Research Company, FMR Co., Inc. and Fidelity Distributors Corporation, SEC Rel. Nos. IC-33683 (Nov. 14, 2019) (notice) and IC-33712 (Dec. 10, 2019) (order); In the Matter of Natixis Advisors, L.P. and Natixis ETF Trust II, SEC Rel. Nos. IC-33684 (notice) (Nov. 14, 2019) and IC-33711 (Dec. 10, 2019) (order); In the Matter of Precidian ETFs Trust, et al., SEC Rel. Nos. IC-33440 (April 8, 2019) (notice) and IC-33477 (May 20, 2019) (order); and In the Matter of T. Rowe Price Associates, Inc. and T. Rowe Price Equity Series, Inc., SEC Rel. Nos. IC-33685 (Nov. 14, 2019) (notice) and IC-33713 (Dec. 10, 2019) (order).

[6] https://www.sec.gov/rules/sro/nysearca/2020/34-88625.pdf; https://www.sec.gov/rules/sro/nasdaq/2020/34-88561.pdf; and https://www.sec.gov/rules/sro/cboebzx/2020/34-88566.pdf

Step 3: Inform shareholders of the conversion and the benefits and process

Adequacy of notice

The adequacy of both the content and timing of a notice of the reorganization to the mutual fund shareholders will be one of the more important procedural fairness issues for the SEC. The content of such notice should be sufficient for shareholders to evaluate the impact of the proposed reorganization on their financial interests. The fund manager will especially need to substantiate the benefits of becoming an ETF in their communications and filings. Among other things, disclosures should contain a clear and concise explanation of ETF share market pricing, bid/ask spread, and associated risks. The timing must be adequate to permit any shareholder who does not want to receive ETF shares to redeem the mutual fund shares prior to the transaction.

Expense ratio

Either a fund conversion or a reorganization would result in changes to how the fund's expense ratio is comprised. All ETFs resulting from mutual fund conversions to date have lowered their expense ratio one way or another. Predominantly, this is being done by lowering the management fee. This postures the ETF for future competitive growth and ranks as an important economic benefit for the mutual fund shareholders for maintaining their investment post conversion.

One way the management fee reduction is realized is by having the management fee be the sole expense of the ETF under a unitary fee arrangement. The vast majority of ETFs are structured using a unitary fee, which generally matches the investment advisory ("IA") fee of the mutual fund. If the adviser, investment objective, and strategy remain consistent from the mutual fund to the ETF, then the IA fee would likely remain the same as well.

However, under a unitary fee structure the fee generally includes all operational ETF expenses that a mutual fund typically does not include in its management fee. Note that a ETF unitary fee, similar to a mutual fund management fee, will, however, exclude brokerage, taxes and certain other expenses.

Some managers may choose to lower the unitary fee to better compete with other ETFs. Under a unitary fee structure, investors are not typically charged 12b-1 and 'other' fees by an ETF that externalizes distribution charges, revenue sharing, and provider costs from the fund and shareholders. Managers should be cognizant of their ETF peer group and where similar products are priced. BBH's ETF Investor Survey has shown a consistent theme in recent years that ETF expense ratios are one of the most critical elements for investors when selecting a product *(see Figure 4)*.

Figure 4: Ranking of the top three areas of importance for investors in 2021 when selecting ETFs, compared to the 2020 ranking

Source: BBH 2021 Global ETF Survey

Share classes

In the US, ETFs only have one share class. To the extent the converting mutual fund has multiple classes, firms should consider the best path forward to collapsing the mutual fund share classes ahead of a reorganization to an ETF, if necessary. Managers will need to consider which share class presents the best performance and track record to maintain and carry to the ETF, and which share class fee structure may be similar in structure to the ETF – this may be an institutional share class or equivalent versus classes with 12b-1 fees or sales loads. Additionally, a clear road map on converting a multi-class fund will require communication to shareholders and intermediaries, helping to maintain shareholder suitability.

Taxes

One main driver of managers seeking to convert mutual funds to an ETF is potential negative tax consequences resulting from mutual funds sitting on large unrealized capital gains. ETFs that allow for in-kind creation and redemption activity typically enjoy a reduced tax footprint compared to mutual funds, as in-kind trading is tax exempt. Managers can select which tax lots to relieve via in-kind redemptions, thus reducing the taxable gains passed along to shareholders. For mutual fund managers, this is a major benefit of ETFs. Managers considering an ETF reorganization should be aware that any unrealized gains or losses in the mutual fund will carry over to the ETF. Depending on the reorganization event, the conversion may be a tax-free event and the basis could remain the same post-conversion. Under this scenario, the new ETF may be able to transfer out highly appreciated assets when redemption orders are placed by the funds' APs.

Managers should work with their tax advisors and regulators to better understand how any unrealized gains can be treated in an ETF reorganization.

While the conversion itself may be deemed tax exempt, there may be shareholder redemption activity and portfolio changes that could present taxable events to shareholders. Managers may choose to elect to redeem fractional shares of the mutual funds held by investors. Such fractional share redemptions could result in taxable gains to the fund. While many broker-dealers and intermediaries may be able to support trading fractional ETF shares on their platform, managers should engage all their intermediaries to better understand the support they may provide. If fractional shares are not permitted on their platforms or on the books of the TA supporting direct shareholders, redemptions may be required and must be disclosed to shareholders of the fund board.

Funds holding foreign securities may also need to sell local positions to transfer assets in an affiliated fund merger where in-kind transfers from the mutual fund to ETF account may not be permitted under local regulations. Additionally, the ETFs listing exchange rules and exemptive relief (for semi-transparent ETFs) may also require portfolio changes to comply with listing standards and regulatory approvals. All these portfolio changes may also trigger taxable events for shareholders.

Step 4: Ensure you are ETF ready

ETF operations

While ETFs enjoy many of the same operational requirements as a mutual fund, there are unique, day-to-day requirements that a firm must be aware of and monitor to support a new ETF business. The calculation and delivery of the portfolio composition file, the receipt of creation and redemption orders from APs, and the use of in-kind trading may present nuances and additional operational requirements for managers considering this type of fund reorganization as their entry into the ETF market. Firms should look to educate not only their internal constituents but confirm their existing service providers have the capabilities needed to support ETFs.

Authorized Participants (APs) & Market Makers

As managers approach the conversion, they should engage APs and market makers. It's critical that ETFs have APs under agreement to facilitate creation and redemption orders on day one and market makers to match buyers and sellers over the exchange. Additionally, these firms can help managers assess any potential changes to their portfolio as they convert from a mutual fund to an ETF.

The mutual fund holdings need to enable a liquid, deliverable ETF basket for the APs and market makers to trade. Additionally, the basket should be tradeable in a way that is compatible with the large aggregations of ETF shares called Creation Units, the blocks of ETF shares utilized in the creation and redemption process. Additionally, managers of international strategies may want to work with a market maker to confirm the portfolio is using the best tradeable lots sizes for specific securities, remove illiquid positions, or even limit the size of the basket to enable it to be traded in a cost-effective manner. These firms may also assist in creating customized baskets post conversion to help facilitate these changes in a tax efficiency manner.

Capital Markets

Firms may consider adding staff or assigning some of their team to the ETF business. For example, most ETF firms employ a Capital Markets group (or individual) who is responsible for building relationships with APs and market makers, monitoring trading and spreads, approving creation and redemption orders and presenting ETF activity to the board. This is often a new role for traditional mutual fund firms and one that will often lead to discussions with APs, exchanges, market makers, and other ETF ecosystem partners. Ideally, this role would be part of a reorganization road map given its widespread integration in the ETF market.

Compliance Policies

Additionally, a firm's 38a-1 compliance program may need to be amended to account for exchange-based trading, monitoring of spreads and APs, design of basket policies and procedures and the presentation of fund performance based on share trading prices as well as NAV per share. Chief compliance officers as well as chief operating officers will likely need to affirm to their board in advance of the fund reorganization new controls and oversight that will be implemented to support the new ETF business.

Firms will also need to examine their underlying strategy and positions to confirm that such strategies and positions will meet the ETF Rule's requirements and listing standards, as applicable. For firms looking at a non-transparent actively managed ETF model, the exemptive relief currently only allows for exchange-traded securities trading synchronous to the U.S. market. Beyond these considerations, managers should be aware that APs will want to discuss the portfolio and confirm it's tradable, the costs associated with trading and hedging, and better understand the portfolio strategy.

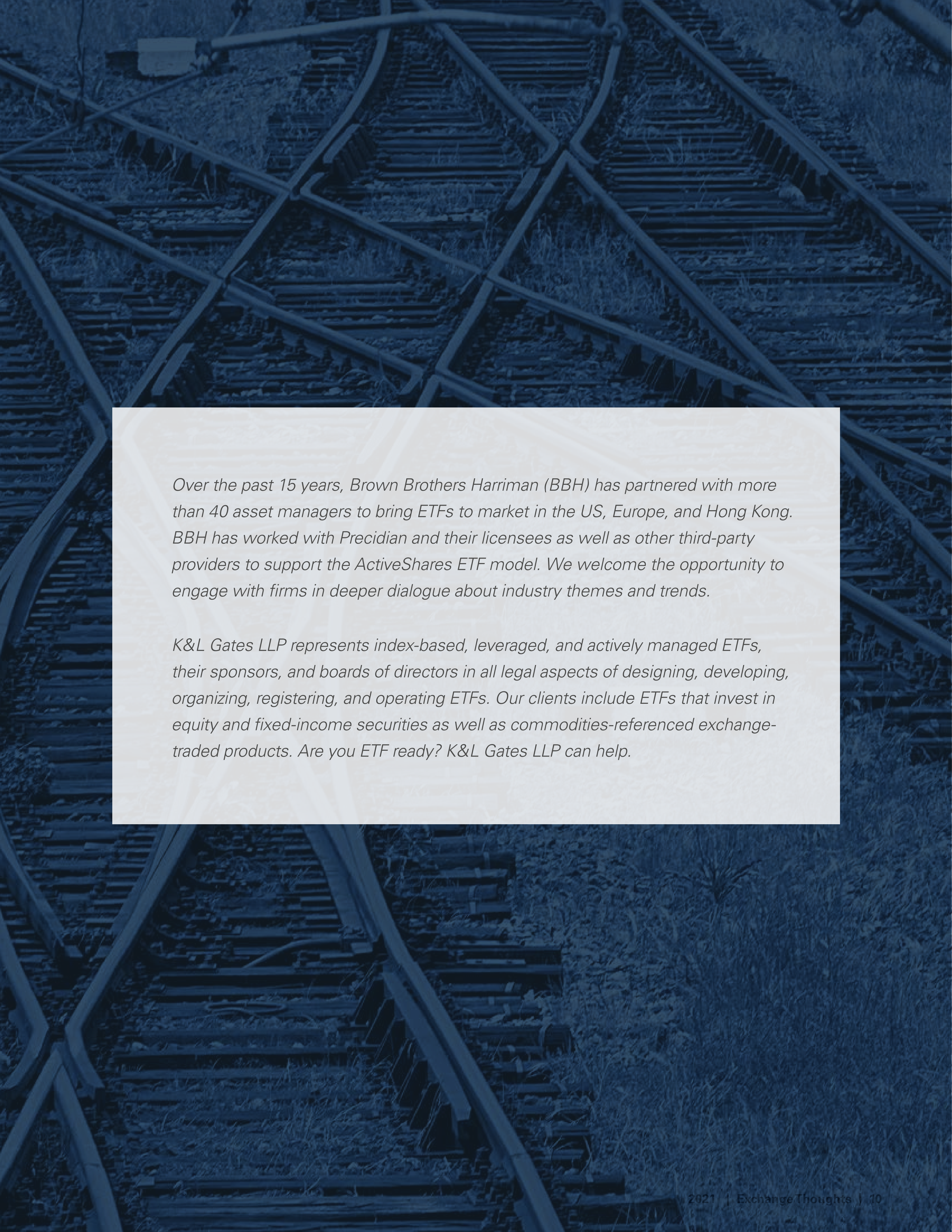
Distribution Strategy

Lastly, and perhaps most importantly, are the impacts an ETF business can have on a firm's distribution team. As ETFs trade over the exchange, it can be difficult to track underlying buyers of the products. Sales teams may need to consider how they can access this information from third-party data firms or from their intermediary partners, likely with additional costs. As mentioned, converting a mutual fund to an ETF may present changes to the access the mutual fund has with intermediary partners. While ETFs typically do not charge 12b-1 fees to shareholders, revenue sharing arrangements with intermediary partners do exist between the ETF sponsor and the respective platforms. As firms enter the ETF market, they should engage their distribution partners to better understand any potential changes to current business incentives that an ETF wrapper may present.

Incentivizing the sales team to market the ETFs may be part of potential changes to distribution strategy and sales compensation firms should consider. Training sales professionals on the nuances of the ETF wrapper will also be critical as their wholesaling efforts will likely require commentary on how best to trade the new product and spread analysis and connections to liquidity providers (e.g. market makers). Installing a Capital Markets person or hiring an ETF specialist within the sales team may aid in these training discussions during the reorganization process as well as on-going product support.

Summary

Managers considering the switch to an ETF as well as setting out the benefits of converting by way of investor communications, must be prepared for a thorough evaluation of its existing operational structure. A manager must also consider the mutual fund's investor base, regulatory options for making the switch, exchange listing rules, preparing for SEC exemptive relief, operational considerations and overall process fairness. After addressing business considerations attendant to the ETF ecosystem, a fund manager making the switch must have a coherent distribution strategy in place prior to a conversion.



Over the past 15 years, Brown Brothers Harriman (BBH) has partnered with more than 40 asset managers to bring ETFs to market in the US, Europe, and Hong Kong. BBH has worked with Precidian and their licensees as well as other third-party providers to support the ActiveShares ETF model. We welcome the opportunity to engage with firms in deeper dialogue about industry themes and trends.

K&L Gates LLP represents index-based, leveraged, and actively managed ETFs, their sponsors, and boards of directors in all legal aspects of designing, developing, organizing, registering, and operating ETFs. Our clients include ETFs that invest in equity and fixed-income securities as well as commodities-referenced exchange-traded products. Are you ETF ready? K&L Gates LLP can help.

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On September 7, 2021 State Street Corporation and BBH announced that they have entered into an agreement for State Street to acquire BBH's Investor Services business, including its custody, accounting, fund administration, global markets and technology services. Following the transaction, BBH will continue to independently own and operate its separate Private Banking and Investment Management businesses. The parties are targeting the first quarter of 2022 to complete the acquisition, subject to regulatory approvals and customary closing conditions.