Converting a Mutual Fund to an ETF: Key Considerations

Bibb Strench, Partner
Investment Management Group
Thompson Hine LLP
202.973.2727
Bibb.Strench@ThompsonHine.com

www.ThompsonHine.com

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Thompson Hine

Key Notes:

- **The ability to convert mutual funds into ETFs could greatly facilitate an asset manager’s goal to enter the ETF business.**
- **Asset managers can take advantage of the new non-transparent, actively managed ETF to convert actively managed mutual funds.**
- **Certain issues still need to be resolved before the first mutual fund to ETF conversion takes place.**

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Save the Date:
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Introduction

Asset managers are exploring the idea of converting mutual funds into exchange-traded funds (ETFs). This comes at a time when the Securities and Exchange Commission (SEC) has allowed the first non-transparent, actively managed ETF, which enables asset managers to offer their actively managed strategies in an ETF product without divulging the “secret sauce” behind them. This combination of regulatory developments could pave the way for mutual fund complexes to transform some or all of their mutual funds into non-transparent, actively managed ETFs. Asset managers of actively managed mutual funds less sensitive about daily disclosing their investment portfolios could convert those funds into traditional, fully transparent ETFs.

To date, no mutual fund has been converted into an ETF. Such a conversion raises regulatory and operational issues, none of which are insurmountable. Below, we discuss the issues and steps that asset managers and their counsel need to consider in converting a mutual fund into an ETF.

Create a Realistic Timetable for Conversion

Asset managers should begin to consider whether converting mutual funds to ETFs makes sense, recognizing that regulatory obstacles must first be cleared before the first conversion may take place.

Asset managers considering mutual fund to ETF conversions should understand that such conversions have not been sanctioned by regulators and it may take some time for the SEC, aided by their counsel and service providers, to work through and solve the issues raised by such conversions. The SEC staff has been only recently made aware of certain asset managers’ desire to convert their mutual funds to ETFs. At this stage, the industry and SEC staff are inventorying the issues and beginning the early stages of analysis. No firm to our knowledge has filed any regulatory documents to effect such conversions. While the SEC has allowed conversions of closed-end funds to ETFs and Canadian regulators have allowed mutual funds to convert to ETFs, there is no assurance that the agency will make available this option to mutual funds or that it will not impose overly burdensome conditions.

With that said, the SEC staff has signaled a willingness to examine how mutual funds can be converted to ETFs under current regulations. It is therefore not premature for fund complexes interested in conversions to begin analyzing their fund line-ups, particularly focusing on what mutual funds might have investment strategies and investment portfolios most suited for an ETF. Assuming the industry obtains a regulatory green light, asset managers should anticipate a timeline of several months to accomplish a conversion.

Establish Brokerage Accounts for Shareholders

An asset manager, working with its counsel and other service providers, will have to effect the exchange of the shares of the mutual fund held by its existing shareholders in accounts at the mutual fund’s transfer agent for shares of the ETF that must be maintained in accounts at broker-dealers.

Mutual fund shares and ETF shares are owned by shareholders in different types of accounts. Mutual fund shares generally are held in two ways: directly with the mutual fund’s transfer agent or indirectly in an omnibus or platform account, both through an accounting/registration format unique to mutual funds. ETF shares, like the shares of ordinary corporate issuers, are held by shareholders in a brokerage account. When the mutual fund shares are exchanged by a shareholder, he or she will receive ETF shares that must be held in a brokerage account. As a result, the shareholder will have to take some affirmative action to set up a brokerage account to house the ETF shares he or she receives after the conversion.

Since the asset manager knows the identities of shareholders of who hold their shares at the mutual fund's transfer agent, it might be able to facilitate the transfer by directing such shareholders to set up brokerage accounts at an affiliated or unaffiliated broker-dealer, cancel the mutual fund shares from the shareholder's account at the transfer agent and deliver shares with the same value to an account established in the shareholder's name at the broker-dealer. It would need the cooperation of the broker-dealer sponsor of a platform to accomplish the same task with respect to shareholders who own mutual fund shares through an omnibus arrangement. From an operational standpoint, it may be a challenge to program mutual fund transfer agent systems to interface with brokerage systems. It will also be necessary to communicate how the conversion will be effected to The Depository Trust & Clearing Corporation (DTCC) and address any issues raised by DTCC.

A vexing issue is that some action needs to be taken by a shareholder to open a brokerage account and the shareholder may do nothing, even if given the option to do so by the mutual fund's transfer agent. In the case of shares held in an omnibus account, the current distribution arrangement with the platform sponsor may need to be unwound and renegotiated and such sponsor may seek some economic incentive to assist with the conversion. There may be other solutions or necessary steps, such as providing shareholders with notice that if they do not set up a brokerage account, their shares will be redeemed for cash prior to the conversion or their new ETF shares will be held in their name in another account pending their instructions.

Complicating this process is the fact that mutual fund shares are held in a number of types of accounts, including IRA and retirement plans. ERISA and other applicable law will have to be carefully examined to address any legal issues associated with converting these accounts, which likely will involve consultation with the person or entity responsible for such accounts (e.g., the plan fiduciary).

Select the Type of Conversion

An asset manager will have to decide what type of conversion is preferable: a direct conversion of the mutual fund into an ETF or the reorganization of the mutual fund into a newly established ETF entity or shell.

Both mutual funds and ETFs typically are series of a trust or corporation. The most straightforward and appealing approach to conversion is to simply change or redesignate the mutual fund series into an ETF series. While simple in concept, such a direct conversion may be more complex from a legal standpoint. The firm will have to examine whether the trust's governance documents would allow such a conversion. In addition, the state law that governs the trust or company may not expressly allow such conversions or be ambiguous on this issue.

On the flip side, reorganizing the mutual fund series into a newly created ETF series requires more steps but arguably would be simpler in terms of legal issues. A trust may have both mutual fund and ETF series and the conversion would merely involve the mutual fund series' assets being transferred to the newly created ETF series in the same trust or company in exchange for ETF shares that would be distributed to the mutual fund series' shareholders.

It should be noted that an asset manager may desire to convert a mutual fund into an existing ETF with a portfolio of securities, which also would require a reorganization.

Individual circumstances may have a significant impact on selecting the type of conversion, and obtaining advice can be important.

Obtain Shareholder Vote or Conclude that Such Vote Is Not Required

An asset manager may have to obtain approval from the shareholders to convert the mutual fund to an ETF.

Whether or not a shareholder vote is required to effect a conversion is a question that first requires the consideration of the type of conversion: a direct conversion or a reorganization. With respect to the former, a direct conversion does not require a transaction. However, the rights of a shareholder who once held shares of a mutual fund and after the direct conversion holds shares of an ETF would change. This is because mutual fund shares and ETF shares have different rights attached to them. For example, a mutual fund shareholder has the right to redeem his or her shares directly from the issuer for cash (or in some cases, a pro rata share of the portfolio securities the mutual fund owns); an ETF shareholder does not have such a redemption right (unless the shareholder is an Authorized Participant) but does have the right to sell his or her shares on an exchange (a right the mutual fund shareholder does not have). Consequently, whether or not a shareholder vote is necessary may turn on whether the ETF share issued is a new security with different rights.

Shareholder vote may also be required if a mutual fund is reorganized into an ETF. Under Rule 17a-8 under the Investment Company Act of 1940 (1940 Act), the shareholders of the acquired fund (in this case, the mutual fund) must vote to approve a fund reorganization unless:

- the mutual fund and ETF share the same adviser, investment objectives, principal policies and risks,
- the distribution fees will remain the same (or be lower), and
- a majority of the disinterested directors of the acquiring fund are persons who were elected disinterested directors of the acquired fund.

While this is feasible, the SEC staff has not taken a position regarding whether a mutual fund may be reorganized into an ETF without shareholder vote in reliance upon Rule 17a-8. If that rule is deemed available, the asset manager nevertheless should consider sending an informational statement to the mutual fund shareholders disclosing information about the reorganization.

Additionally, a mutual fund's governing documents and the applicable state statutory requirements should be reviewed and analyzed to determine whether the mutual fund's shareholders need to approve the reorganization at a shareholder meeting.

If a shareholder vote is required, the direct conversion and reorganization would have to be voted upon in compliance with the SEC's proxy rules and registration rules, including the preparation and filing of the appropriate SEC forms (i.e., Schedules 14A and N-14).

Notify Shareholders

The mutual fund shareholders will have to be notified about the upcoming conversion.

Irrespective of whether a shareholder vote is necessary, shareholders would have to receive ample notice of the conversion. At a minimum, shareholders likely should be notified at least 30 days prior to the conversion. A longer notice period with additional disclosure may be necessary, depending on how brokerage accounts would be set up to effect the conversion, which is discussed above. Notice involves "stickering" the mutual fund's prospectus and Statement of Additional Information and posting information on the mutual fund's website.

Amend Registration Statement and Make Possible Additional Filings

The asset manager will need to amend the mutual fund's registration statement, which houses the prospectus and statement of additional information, to update disclosure about the converted fund.

If an asset manager directly converts a mutual fund into an ETF, it will have to amend the mutual fund's registration statement at least 75 days in advance of the direct conversion to address the conversion. For example, the SEC requires clear disclosure that the fund is an ETF and imposes other ETF-specific disclosures (e.g., the name of the exchange where the ETF trades). If an asset manager reorganizes a mutual fund into a shell ETF series, it will have to file a post-effective amendment to the registration statement at least 75 days in advance of the reorganization adding the shell ETF series to the mutual fund's trust or a new trust, which will include disclosure about the shell ETF. In either event, the asset manager should be prepared to respond to SEC comments, possibly including comments on issues raised herein. In advance of this filing, the asset manager must notify the mutual fund's shareholders about the proposed conversion (as noted above) through the filings of supplements to the mutual fund's prospectus.

If the mutual fund converts into a non-transparent, actively managed ETF, the prospectus will have to be amended to add certain SEC-mandated disclosures unique to this type of ETF, including an explanation of the differences between a non-transparent, actively managed ETF and a fully transparent ETF.

List the ETF's Shares on an Exchange

Before converting the mutual fund to an ETF, the asset manager will file a listing application with the exchange where the ETF shares will be traded.

Since ETF shares trade on an exchange, the asset manager must file an application to list the shares on the exchange. Prior to making the filing, the asset manager must ensure that the ETF will have a portfolio and be managed to an investment strategy that will allow it to meet the rules of the exchange, which are called the "generic listing standards." See below for a discussion of other reasons the portfolio may need to be modified. Most ETFs can comply with the listing rules of a given exchange. However, the ETF may employ a strategy or utilize a type of transaction or security not permitted under the exchange's generic listing standards (e.g., significant use of derivatives). In such a case, it will be necessary for the exchange to file on the ETF's behalf a Rule 19b-4 application with the SEC seeking an amendment to the exchange's generic listing standards to allow the ETF with such characteristics to trade on the exchange.

Create or Modify an Existing Website

While many asset managers have websites for their mutual fund products, the SEC mandates additional disclosures on ETF websites, including certain trading data specific to the ETF.

ETFs currently operate pursuant to exemptive orders, and in the future will operate pursuant to a rule, each of which require mandated website disclosure of certain information about the ETF. The presentation of such disclosure in some cases will require technical modifications to pages on the ETF's website, including coding and programming. For example, the ETF must disclose on a website its bid/ask spread and the spread between its share price and net asset value per share. It is well advised that an asset manager make such website modifications well in advance of the conversion, especially because there may be unforeseen technical issues.

Modify the Mutual Fund Portfolio and Strategy So It Is Suitable for an ETF, if Necessary

The mutual fund's investment portfolio and strategy employed to manage the portfolio should be examined and modified where necessary to ensure that they are suitable for the ETF product.

Prior to conversion, the mutual fund portfolio may have to be modified so the ETF holding the portfolio is compliant with the applicable SEC exemptive order and the listing exchange's generic listing standards. In addition, the asset manager should consult with the ETF's proposed lead market maker to discuss whether modifications to the ETF's portfolio and investment strategy are necessary to better facilitate the creation and redemption process, including an Authorized Participant's ability to hedge away risk when effecting such transactions. It should be noted that the first permissible non-transparent, actively managed ETFs, which are discussed below, will be restricted with respect to their holdings, including only being able to purchase liquid securities as well as securities that trade on a market that is open at the same time the ETF shares trade. Individual characteristics of the mutual fund's portfolio and investment strategy may have a significant impact on the feasibility of the conversion, and obtaining advice can be important.

Eliminate Classes of Shares

A multiple class mutual fund will have to shed all but one of its classes of shares prior to or at the time of the conversion.

Many mutual funds have multiple classes of shares; ETFs are permitted to have only a single class of shares. As a consequence, a converting mutual fund with two or more classes would have to either collapse all of its classes into a single class prior to the conversion or exchange each of the classes of mutual fund shares for the single class of ETF shares. Prior to effecting the conversion of a multiple class mutual fund into an ETF, the mutual fund's multi-class plan adopted pursuant to Rule 18f-3 under the 1940 Act should be examined to see if it contemplates and allows the conversion. If not, the consolidation of share classes or conversion of them to a single ETF class of shares may require an amendment to the plan.

Also, the mutual fund sponsor should be sensitive to any shareholders who paid a sales load shortly before the planned conversion. One possible consideration to address this issue and the fairness of the conversion to such shareholders would be to close the mutual fund to new investors and additional investments by existing shareholders for a period of time prior to the conversion. Since mutual fund classes are typically tied to distribution arrangements and channels, the asset manager will have to examine how the conversion will impact arrangements with wholesalers, financial intermediaries and other distribution partners.

Obtain an Exemptive Order, if Necessary

To effect the conversion, an exemptive order or an amendment to an existing exemptive order may have to be obtained.

Until proposed Rule 6c-11, the so-called " ETF Rule," is adopted and effective, an exemptive order will be necessary to effect the conversion. For example, a mutual fund exchanging its portfolio securities for ETF shares in a conversion transaction needs exemptive relief from the SEC because only Authorized Participants are permitted under existing exemptive orders to make in-kind purchases of ETF shares. As an alternative to exemptive relief, the SEC staff might consider an amendment to an existing exemptive application or no-action relief. It should be noted that the ETF Rule as currently proposed would allow such transactions, as the rule has been designed to facilitate reorganizations, mergers and conversions. Exemptive relief presumably would not be necessary in cases where a mutual fund directly converted to an ETF because no "create" transaction would occur. An asset manager of a fund complex without an

ETF exemptive order would need one until the ETF Rule is effective. Irrespective of whether the ETF Rule is adopted, an exemptive order is necessary to offer a non-transparent, actively managed ETF.

Seek Board Approval

A board will have to be provided sufficient information to conclude that the conversion is in the best interests of the converting mutual fund and its shareholders.

An asset manager will have to secure the approval of the mutual fund's board of directors to convert the mutual fund into an ETF. The board ultimately must make a finding that the conversion is in the best interests of the mutual fund's shareholders. In addition, if the conversion will be effected through a reorganization, the board will have to make the usual findings and approvals made in connection with such transactions (e.g., no dilution of the mutual fund's shareholders' interest in the converting shares). So the board can make these findings, the asset manager should provide the board sufficient information that makes the case for why the conversion will be beneficial and in the best interests of the converting mutual fund.

With respect to approving the conversion, possible board considerations include:

- representations/analysis regarding the suitability of a mutual fund's portfolio and investment strategy for an ETF product;
- inherent tax advantages of an ETF over a mutual fund, including the fact that most ETFs recognize few or no capital gains in a given tax year;
- fees or expenses in connection with the conversion that will be borne directly or indirectly by the shareholders;
- ETFs generally can operate with lower cash holdings because they do not have to redeem in cash from retail shareholders, which improves performance by reducing cash drag;
- the effect of the conversion on annual fund operating expenses and shareholder fees and services;
- any change in fees or expenses to be paid or borne by shareholders (directly or indirectly) after the conversion;
- any direct or indirect federal income tax consequences of the transaction to shareholders;
- changes in services to be provided to mutual fund shareholders after the conversion;
- any change to the converting mutual fund's investment objectives, policies or restrictions;
- the current tax position of the converting mutual fund's investment portfolio, including any tax benefits or disadvantages to the portfolio associated with the conversion transaction and after the conversion;
- the experience of the adviser and its personnel with respect to managing and operating an ETF; and
- the expected timeline and costs of buying and selling securities to reposition the portfolio to be ETF-compliant and how portfolio repositioning costs will be borne.

Besides making these considerations, the mutual fund's board will have to take a number of other actions, including authorizing certain filings with the SEC, approving changes to service provider contracts and approvals related to shareholder meetings (if necessary).

Ensure Mutual Fund Performance/Accounting Survivorship

An asset manager should be able to use the mutual fund's track record to market the ETF, in part because the ETF will be deemed to be the accounting survivor of the mutual fund.

The mutual fund to ETF conversion should be done in a manner that will allow those marketing the ETF to use the mutual fund's performance track record. This should not be an issue for an ETF seeking to show predecessor performance, especially in the case where the mutual fund directly converts to an ETF. If the conversion is effected through a reorganization that creates a new ETF entity, the asset manager can look to existing SEC no-action letter guidance to take the steps necessary to preserve the use of the converting mutual fund's track record in connection with the marketing of its successor ETF. One of these factors is whether, from an accounting standpoint, the mutual fund continues to exist in its new form.

Because they are different product types, consideration will have to be given to attaching a note to the mutual fund track record disclosure indicating that the mutual fund's track record was not based on share prices as determined by the market. It may be necessary to obtain counsel when drafting this note, which may include describing other differences and providing other explanatory information in anticipation of expected scrutiny from the SEC and FINRA when they review the presentation of the converting mutual fund's past performance.

Consider Converting the Mutual Fund Into a Non-Transparent, Actively Managed ETF

If an asset manager wants to protect its investment management methodology, which could otherwise be reverse engineered through backtesting the daily disclosure of the ETF's holdings, the firm may want to convert its mutual fund into a non-transparent, actively managed ETF.

An asset manager can choose to convert a mutual fund into a traditional fully transparent ETF, which is required to disclose its complete portfolio each business day before trading begins, or a non-transparent, actively managed ETF, which is not required to fully disclose its portfolio. This decision, in large part, will turn on whether the asset manager is concerned that its proprietary investment methodology used to manage the product (i.e., its "secret sauce") will be compromised by competing firms that are able to decipher it through the backtesting of the daily disclosure of the ETF's holdings.

If the asset manager elects to convert into a non-transparent, actively managed ETF, it will have a number of decisions to make. Currently, only one type of non-transparent, actively managed ETF has been allowed by the SEC. The sponsor of that product has made its methodology and other features available to be licensed by third-party asset managers for a fee. Other non-transparent, actively managed ETF models are expected to be available soon after the SEC acts on their exemptive applications. An asset manager also could obtain its own non-transparent, actively managed ETF exemptive order.

Expand Compliance Program to Cover ETFs

The compliance officer for the mutual fund will have to enhance his or her skills of monitoring ETFs and expand the compliance program to have procedures specifically for ETFs.

While there is significant overlap in responsibilities for compliance officers overseeing mutual funds and ETFs since they are both registered investment companies, ETFs have operational differences that pose unique compliance issues and responsibilities. In addition, ETFs are subject to certain rules, staff interpretations and exemptive orders not applicable to mutual funds. Importantly, ETFs must comply with the listing standards of the exchange where they trade. As a result, the compliance program in place for a mutual fund must be modified to cover these additional requirements, which likely will require additional training of compliance personnel.

Structure the Conversion To Be a Tax-Free Event and Address Fractional Shares

The mutual fund to ETF conversion likely will be able to be structured so that it is a tax-free event, except for a small amount of cash that may have to be given to shareholders in a taxable distribution.

As previously noted, the conversion of a mutual fund into an ETF can be a direct conversion or a reorganization of the mutual fund into a newly created ETF shell. Boards and even the SEC likely would not be inclined to permit a reorganization if there would be negative tax consequences for the existing mutual fund shares. With that said, there does not appear to be any impediments to effecting the conversion in a tax-free manner. It should be noted that a direct conversion likely presents fewer tax issues than a conversion made by a reorganization.

In connection with this process, the portfolio of the converting mutual fund should be reviewed to determine its present tax characteristics and the impact, if any, on shareholders with respect to the conversion of that portfolio for ETF shares. Individual circumstances may have a significant impact on the availability of tax-free treatment, and obtaining advice from the mutual fund's auditor and counsel can be important.

Mutual funds issue and have outstanding fractional shares; ETFs, because they trade on a market, do not. Therefore, in a conversion from a mutual fund to an ETF, shareholders may own a fractional mutual fund share that does not quite equal the value of a full ETF share. As a result, the mutual fund shareholder will receive in addition to the ETF shares a smaller dollar amount representing the value of that fractional share. The receipt of this cash equaling the fractional amount could result in a modest taxable gain for the shareholder.

Identify and Address Operational Tasks and Consider Business Implications

The discussion above has largely focused on considerations related to legal issues and requirements. An asset manager considering converting a mutual fund into an ETF also must identify, plan for and execute operational tasks related to the conversion. In addition, the asset manager must consider and weigh a number of business factors, such as how such conversions will impact the marketing of its registered products, including distribution relationships; portfolio manager and other staff modifications to accommodate ETFs; the competitive environment of ETFs, including existing mutual fund fees compared to fees proposed for ETFs; and myriad other factors beyond the scope of this article.