

Converting A Traditional Open-End Fund Into An ETF

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The Securities and Exchange Commission (SEC) recently issued an exemptive order to Precidian ETF Trust (Precidian) that permits an actively managed exchange-traded fund (ETF) to operate without being subject to the daily portfolio transparency condition included in past active ETF orders. Other applications for exemptive relief that would allow similar actively managed nontransparent ETFs are currently under consideration by the SEC and may be granted in the future. Ropes & Gray LLP partners Brian McCabe and Jeremy Smith, along with counsel, Ed Baer, anticipate that many active equity managers may seek to offer their strategies as actively managed nontransparent ETFs, including potentially through the conversion of an existing traditional open-end fund (OEF) into an ETF. Here, the attorneys explain that, while there may be significant obstacles to overcome in converting an OEF into an ETF, they do not believe there is any legal reason such obstacles cannot be overcome.

What benefits would investors see from converting an OEF into an ETF?

Brian McCabe: Tax efficiency would be one of the major advantages of such a conversion. Because ETFs generally satisfy redemptions in-kind, they typically recognize fewer capital gains than equivalent OEFs. As a result, an OEF with significant unrealized capital gains or a tax-managed strategy may represent a compelling opportunity for a conversion, though the potential tax efficiency of an active nontransparent ETF may be partly limited by a requirement that the ETF's cre-

ation basket represent a pro rata portion of the portfolio.

ETFs also tend to be more cost efficient than OEFs. They typically do not have to maintain a cash position or sell securities to meet redemptions, and therefore may operate with less cash drag and lower transaction costs. ETFs also bear significantly lower transfer agency costs than OEFs, and most ETFs do not pay 12b-1 fees.

Finally, ETFs—unlike OEFs—can be traded intraday, which may be attractive for investors who do not want to wait until 4:00 p.m. ET to buy and sell shares.

How would a conversion be effected?

Ed Baer: Through direct conversion or a merger. In a direct conversion, the OEF would convert into an ETF by obtaining an exemptive order and amending its organizational documents to limit redemptions to creation unit aggregations. In a merger, the OEF would merge into a shell ETF that has obtained the necessary exemptive order. In some cases, the “merger” may technically take the form of an asset sale.

What steps would be involved?

Jeremy Smith: Any nontransparent actively managed ETF (NT Active ETF) would need to operate pursuant to exemptive relief from the SEC. The conversion will also involve the filing of various registration statement amendments and prospectus supplements. In addition, the SEC will generally have to authorize listing rules for any NT Active ETF, and the

NT Active ETF will have to meet other SEC requirements applicable to ETFs.

Additionally, the conversion must be approved by the OEF's board. For some OEFs, shareholder approval may also be required under the Investment Company Act of 1940, as amended, applicable state law, the organizational documents or applicable exchange rules. If shareholder approval is required, a joint prospectus/proxy statement on Form N-14 would generally need to be filed with the SEC.

Other steps that may be necessary include, among others, adjusting the OEF's portfolio to be compliant with the conditions of the applicable ETF exemptive relief, consolidating share classes to accommodate the typical single-class structure of ETFs, redeeming fractional shares, and providing a mechanism for OEF shareholders to establish brokerage accounts to hold ETF shares.

Ropes & Gray LLP would be pleased to assist you in analyzing whether a conversion would be appropriate for your business and in structuring the conversion to address your particular facts and circumstances. Please contact the authors for assistance.

To read the Ropes & Gray LLP white paper titled “Converting Traditional Open-End Funds into ETFs,” please visit www.ropesgray.com/MFtoETF.

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