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Converting Mutual Funds into ETFs

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In the July 2019 issue of *The Investment Lawyer*, we published an article on the potential for an open-end fund to convert into an exchange-traded fund (ETF).¹ In this article, we update our analysis of the key considerations in converting an open-end mutual fund (MF) into an ETF and address a number of developments in the ETF industry, including the first two completed mutual fund to ETF conversions.² This article highlights some practical considerations regarding how sponsors can overcome the regulatory and operational hurdles associated with converting a MF into an ETF.

Potential conversions of MFs into ETFs have been discussed for years,³ but now that it has never been easier to develop and launch diverse types of ETFs, conversions have become a reality. The long-awaited ETF Rule is now in place,⁴ and since 2019, the Securities and Exchange Commission (SEC) has provided relief necessary for sponsors to launch “non-transparent” or “semi-transparent” active ETFs (collectively Semi-Transparent Active ETFs) that do not make their portfolio holdings available on a daily basis like traditional ETFs.⁵ These regulatory developments have prompted many new sponsors to offer their investment strategies in ETF form, and converting existing MFs to ETFs may offer an appealing way for sponsors to enter the market with scale and a performance track record.

Executive Summary

At a high level, a conversion of a MF into an ETF involves the following considerations:

- *Level of Transparency of the ETF’s Portfolio Holdings.* If the ETF’s sponsor is willing to make an ETF’s portfolio holdings publicly available on a daily basis, the ETF may rely on the ETF Rule after a conversion is effected.⁶ If the ETF sponsor requires that the ETF’s holdings be shielded from the public—whether partially or completely—the sponsor will need to obtain and rely on exemptive relief. This relief can be either “short-form” relief based on exemptions obtained by and licensed from other sponsors,⁷ or it could be novel relief. Short-form relief has in some cases been obtained in approximately 2-3 months using an expedited process, while novel relief typically takes much longer.
- *Direct Conversion or Merger.* The transformation to an ETF can be effected through a direct conversion or a merger. In a direct conversion, the MF converts into an ETF by amending its fund documents and registration statement as necessary. In a merger, the MF merges into a shell ETF created to effect the transformation. In either case, the resulting ETF must have obtained the necessary exemptive order (a Semi-Transparent Active ETF) or must operate pursuant to the ETF Rule (a traditional ETF). In some cases, the

“merger” may technically be effected through an asset sale.⁸

- *SEC Exemptive Relief and Regulatory Filings.* As noted above, any Semi-Transparent Active ETF would need to operate pursuant to exemptive relief from the SEC. If approved, any conversion will also involve the filing of various prospectus supplements and amendments. In addition, the SEC generally will have to authorize the exchange listing rules for any Semi-Transparent Active ETF, and the Semi-Transparent Active ETF will have to comply with SEC market trading relief and meet other requirements applicable to ETFs. ETFs that are able to operate pursuant to the ETF Rule will be able to take advantage of existing exchange listing rules and SEC market trading relief.
- *Board and Shareholder Approvals and Communications.* The necessary steps to effect a conversion must be approved by the MF’s board. Shareholder approval may also be required under the Investment Company Act of 1940, as amended (1940 Act), applicable state law, the MF’s organizational documents, and/or applicable exchange rules. If shareholder approval is required by a MF’s organizational documents, Rule 17a-8 under the 1940 Act or otherwise, a joint prospectus/proxy statement generally would be filed with the SEC on Form N-14.
- *Other Steps.* Other potential steps include, among others, adjusting the MF’s portfolio to be compliant with the conditions of any applicable exemptive relief, consolidating share classes to accommodate the typical single-class structure of ETFs, arranging for MF shareholders to designate or establish brokerage accounts and redeeming fractional shares.

Background

The SEC’s adoption of the ETF Rule and approval of the Semi-Transparent Active ETF

models mark a significant evolution in the regulation of ETFs. The approval of various Semi-Transparent Active ETFs paved the way for active equity managers seeking to launch semi-transparent ETFs, either following one of the Semi-Transparent Active ETF models or pursuant to exemptive relief based on a different model.

Conversion Mechanics

There are two basic approaches to converting a MF into an ETF: (1) a direct conversion and (2) a merger. While a direct conversion may involve fewer procedural steps than a merger, different or additional approvals may be required in connection with a direct conversion. Careful consideration should be given to the relative advantages or disadvantages of the two basic approaches in light of the specific structure and operations of the existing MF and the goals and preferences of the sponsor.

1. *Direct Conversion.* In a direct conversion, the MF converts into an ETF by amending its registration statement and organizational documents, and adjusting its operations accordingly. In some cases, a MF’s organizational documents may not contemplate series operating as ETFs and may require a shareholder vote to make the necessary changes. Depending on the nature of the ETF, an SEC exemption may be necessary.
2. *Merger/Asset Sale.* A shell ETF is created, potentially with the same Board and the same investment policies and objectives as the MF. A shell ETF will have to file a registration statement with the SEC. The MF then merges into the ETF (depending on the form and state of organization of the MF and the ETF, the “merger” may technically be effected through an asset sale). Such a merger or asset sale could require the affirmative vote of shareholders of the non-shell fund under the fund’s organizational documents, state law or under Rule 17a-8, where applicable.

Semi-Transparent Active ETF Models

Many active equity managers may have been reluctant to launch active ETFs due to concerns that daily portfolio transparency would result in front-running of positions that are bought or sold over more than one trading day or free riding by investors that might seek to replicate the disclosed portfolio outside of the Fund (and thereby avoiding management fees and other expenses). The terms of the Semi-Transparent Active ETF relief seek to address those concerns. However, an ETF operating under one of the approved Semi-Transparent Active ETF models may hold only exchange-traded common stocks, common stocks listed on a foreign exchange that trade on such exchange synchronously with the ETF's shares, ETFs, exchange-traded notes, exchange-traded preferred stocks, exchange-traded American Depositary Receipts (ADRs), exchange-traded real estate investment trusts, exchange-traded commodity pools, exchange-traded metals trusts, exchange-traded currency trusts, and exchange-traded futures contracts that trade synchronously with the ETF's shares, as well as cash and cash equivalents. An ETF operating under these models also cannot borrow money or invest in illiquid investments and cannot hold short positions, which may affect the ETF's ability to engage in certain hedging activities. Some key features of these models include:

- **Precidian Model**
 - The Precidian model provides no daily disclosure of portfolio holdings to authorized participants (APs) or other market participants, but does supply a verified intraday indicative value (VIIV) of its portfolio every second of the day.
 - Creations and redemptions are handled confidentially by a broker-dealer selected by and acting on behalf of an AP known as an AP representative.⁹
- **Proxy Portfolio Models (Fidelity, T. Rowe, Natixis/NYSE, Blue Tractor and Invesco)**
 - These are “semi-transparent” models that provide some transparency into the ETF's

holdings and the baskets available to APs and other market participants on a daily basis.

- While these models are broadly similar in that they provide a measure of daily portfolio transparency to APs and other market participants, they differ from each other in the amount of transparency they provide and in how they shield portfolio changes, and are all very different from the Precidian model.

ETFs utilizing these models have been operating for a little over a year, and sponsors continue to seek novel and expanded versions of this relief.¹⁰ While spreads and premiums/discounts on products that have been launched have been within the range of spreads that are typical for newly-launched US equity ETFs,¹¹ these products all launched after the March 2020 market volatility and they have not yet been tested in extreme market environments.¹² To date, none of the completed or announced MF to ETF conversions involve Semi-Transparent Active ETFs.

Potential Reasons for Converting a Mutual Fund to an ETF

There may be significant benefits to converting a MF to an ETF. Some of the key benefits are listed below, though other significant benefits may exist depending on the particular facts and circumstances.

- *Tax Efficiency.* Because they frequently transact in kind, ETFs often do not have to sell securities (and thereby potentially realize capital gains) to meet redemption requests. As a result, ETFs typically recognize fewer capital gains within their portfolios than equivalent MFs. ETFs also generally can minimize the realization of capital gains by satisfying redemption requests using the lowest cost basis lots of each instrument that is part of the ETF's redemption basket. A MF with significant unrealized capital gains or a tax-managed strategy may represent a compelling opportunity for a conversion.

- *Less Cash Drag and Lower Operational Costs.* ETFs do not typically have to maintain a cash position or sell securities to meet redemptions and therefore may operate with less cash and incur lower transaction costs. ETFs also typically bear significantly lower transfer agency and shareholder servicing costs than MFs, and most ETFs do not pay Rule 12b-1 fees,¹³ further reducing the costs borne by investors, at least as part of the investment wrapper. Unlike MFs, ETFs are also not subject to state registration (or blue sky) fees. Finally, ETFs may be attractive to managers of MFs because investment advisers to ETFs have historically paid lower levels of revenue-sharing and similar payments to intermediaries.¹⁴
- *Investor Interest.* Many investors have been drawn to ETFs by their relative tax efficiency, lower operating costs, the ability to trade shares intraday using flexible order types, and the ability to borrow, lend, pledge, margin, and sell ETF shares short. ETFs are often the preferred vehicle in model portfolio arrangements and most robo-advisors predominantly utilize ETFs in their portfolio solutions.

Key Considerations When Converting a Mutual Fund to an ETF

SEC Exemptive Order

Any Semi-Transparent Active ETF will need to operate pursuant to an exemptive order. Whether the MF or the Semi-Transparent Active ETF has to file the exemptive application will depend on whether the conversion is effected through a direct conversion or a merger: If a MF converts directly into a Semi-Transparent Active ETF, the converting MF would apply for the order; if the conversion is effected through a merger, the shell ETF would apply for the order.

Licensing

The Semi-Transparent Active ETF applications contend that certain aspects of the ETFs described

therein are subject to intellectual property rights and contemplate licensing of the intellectual property to other Semi-Transparent Active ETFs that seek to rely on that intellectual property. The necessary licensing will add to the cost of operating a Semi-Transparent Active ETF, but is likely to result in a faster time to market.

Board Approval

Managers contemplating a conversion of a MF into an ETF should carefully craft a strategy for communicating the conversion plans to the funds' Boards. The Board of the MF and, for a merger, the ETF, will have to approve the conversion or merger. In doing so, the Board generally must find that any proposed merger is in the best interest of the funds and that existing shareholders will not be diluted as a result, consistent with Rule 17a-8 under the 1940 Act. A Board would likely perform a similar analysis in evaluating a proposed direct conversion. In either case, the Board should be provided all information reasonably necessary to evaluate the proposal. Given the structural differences between MFs and ETFs, such information may include, among other things, information relating to:

- the loss of the right to redeem individual shares;
- the need for shareholders of the ETF to designate or establish a brokerage account in order to trade the ETF shares following the conversion transaction;
- the intraday liquidity provided by the ETF structure;
- changes to the Fund's principal investment strategies and how the Fund has historically invested;
- the expected portfolio turnover and the tax consequences that will be incurred in connection with the conversion;
- the costs of the conversion and who will bear those costs;
- the trading costs (in terms of bid-ask spreads) expected to be borne by ETF shareholders after the conversion;

- the timeline for the conversion;
- the expected effect of the conversion on the Fund's total operating expenses;
- the sponsor's ability to facilitate an effective arbitrage mechanism through arrangements with APs and market makers; and
- the potentially significant tax benefits of operating as an ETF.

Various other Board approvals will be needed as well. For example, the Board may have to authorize SEC filings (such as the registration statement amendments or exemptive applications discussed herein), amend or approve compliance procedures to reflect an ETF's operations, provide an approach for dealing with a MF's multiple share classes (if applicable), and authorize various other steps of the conversion or merger, including (where applicable) a shareholder meeting. Finally, the Board may need to be educated about how the operation of ETFs differs from that of MFs, especially with respect to the functioning of the arbitrage mechanism and the creation and redemption processes.

Form N-1A Registration Statement and Prospectus

Whether the conversion is effected through a direct conversion or a merger, various registration statement amendments or prospectus updates will be required in connection with the conversion.

- *Filings.* For a **direct conversion**, the MF's prospectus will need to be supplemented, presumably shortly after the Board approves the conversion, to disclose the intended conversion. In addition, the MF's registration statement will need to be amended in a filing pursuant to Rule 485(a) under the Securities Act of 1933 (Securities Act) to reflect the conversion. A registration statement amendment filed pursuant to Rule 485(a) under the Securities Act is subject to a 60-day review period before the amendment

can become effective, during which period the SEC Staff may provide comments on the filing.

For a **merger**, a new registration statement will need to be filed for the newly-created shell ETF, the effectiveness of which may require acceleration by the SEC Staff if it is the first series of a new SEC registrant. If the shell ETF is a series of an existing entity with an effective registration statement, the shell ETF could be added in a registration statement amendment pursuant to Rule 485(a) under the Securities Act, which would be subject to a 75-day review period.

- *Disclosure.* The Semi-Transparent Active ETF exemptive applications mandate certain disclosures for the Semi-Transparent Active ETF, including disclosure highlighting the specific risks of these models. For example, the prospectus for a Semi-Transparent Active ETF must disclose the possibility of reverse engineering of the strategy by competitors, the potentially wider bid-ask spreads and larger premiums or discounts at which they may trade due to the lack of transparency, and the potentially greater trading costs. In addition, the websites for Semi-Transparent Active ETFs also must disclose information about the trading conditions (for example, when bid-ask spreads relative to net asset value (NAV) exceeds 2 percent for 30 or more days in any quarter or 15 days in a row) of which notice must be provided to the Boards. Exemptive orders issued by the SEC in the future to other Semi-Transparent Active ETFs may require disclosure of different risks or require other specific statements.

Listing the ETF on an Exchange

The ETF needs to be listed on an exchange. Generally, an ETF seeking to list on an exchange would need to either obtain the approval of the SEC's Division of Trading and Markets (T&M) or satisfy certain specified generic listing standards

previously approved by the SEC Staff. While there are generic listing rules for ETFs that operate pursuant to the ETF Rule, they are not available to a Semi-Transparent Active ETF.¹⁵ Until generic listing rules are available, a Semi-Transparent Active ETF would be able to list on an exchange only if an application pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (Exchange Act)¹⁶ were approved by T&M. The Rule 19b-4 process can take up to nine months and involves an additional layer of regulatory review, introducing significant uncertainty into the design and time frame for launching the ETF and completing the conversion. In light of the required application process, sponsors may wish to communicate with the relevant listing exchange during the conversion planning stage.¹⁷

Shareholder Approval

A key question in evaluating and structuring a potential conversion from a MF into an ETF is whether approval by the shareholders of the MF, the ETF, or both will be required. Approval by the MF's shareholders may be required under the fund's organizational documents, state law or Rule 17a-8, where applicable.¹⁸ If approval by the ETF's shareholders is required, it may be possible for that approval to be obtained from the ETF's sole shareholder prior to listing.

- *The 1940 Act.* Rule 17a-8 under the 1940 Act generally permits mergers between affiliated funds, subject to certain conditions, and does not require shareholder approval if certain conditions are satisfied. Generally, Rule 17a-8 permits a merger between a MF and an affiliated ETF without a shareholder vote if the advisory agreements and fundamental policies of the MF and the ETF are not materially different, independent Board members of the MF who were elected by its shareholders represent a majority of the independent Board members of the ETF, and the ETF does not have a plan pursuant to Rule 12b-1 under the 1940 Act

(Rule 12b-1 Plan) that authorizes greater payments for distribution than does the MF's Rule 12b-1 Plan.¹⁹

- *State Law and/or Organizational Documents.* The laws of the state under which a MF or ETF is organized may require a shareholder vote prior to effecting the conversion or merger. The Declaration of Trust or other organizational documents of the MF or the ETF may also require shareholder approval.
- *Listing Rules for Existing ETFs.* If the MF is merging into an existing ETF that is already listed on an exchange, approval by the ETF's shareholders may be required under applicable listing rules. For instance, both Nasdaq and the NYSE require shareholder approval before a listed company can (1) issue transaction securities that will represent 20 percent or more of the outstanding voting power before the issuance or that will constitute 20 percent of the number of outstanding shares before the issuance; or (2) issue securities that will result in a change of control of the issuer. In such circumstances, communications with the relevant exchanges may be necessary during the planning stage, as it may or may not be possible to obtain the requisite shareholder approval prior to listing.

Shareholder Communications

As part of a merger or asset sale, the MF shareholders would receive shares of the ETF in exchange for their shares of the MF. ETF shares that are to be offered in connection with a merger for which approval by the MF's shareholders is required generally must be registered on Form N-14. The heart of Form N-14 is a combined prospectus/proxy statement that simultaneously registers the ETF shares for public offering and solicits proxies from the shareholders of the MF. The Form N-14 is publicly filed with the SEC and the prospectus/proxy statement is distributed to shareholders. The Form

N-14 will contain disclosures regarding material differences between the MF and the ETF and will describe the principal risks of the ETF. Even if shareholder approval is not required in connection with a conversion, sponsors may wish to consider whether the ETF should file with the SEC and distribute to shareholders a prospectus/information statement (essentially, a joint prospectus/proxy statement that does not request a shareholder to vote) on Form N-14.²⁰

Preparing the MF for Conversion

As discussed above, a Semi-Transparent Active ETF will operate pursuant to an exemptive order that imposes certain specific conditions on the Semi-Transparent Active ETF's investments and operations. Similarly, an ETF that operates under the ETF Rule will have to comply with the requirements and conditions of the Rule. In some cases, those conditions, as well as other structural differences between MFs and ETFs, may require certain changes to be made to the MF's existing portfolio prior to the completion of the conversion. The exact nature and extent of any required changes will depend on the current operations of the MF and the specific conditions described in the exemptive order or in the ETF Rule, but likely include:

- *Consolidating Share Classes.* Most ETFs are unable to offer multiple share classes. If the MF offers multiple share classes, the classes may, in the case of a direct conversion, need to be consolidated into a single class prior to the conversion. The consolidation of share classes may require an amendment to the MF's multi-class plan adopted pursuant to Rule 18f-3 under the 1940 Act to adjust the eligibility conditions for shares of the class into which the other classes will be consolidated. In addition, sponsors might consider whether to discontinue sales of MF shares that are subject to sales charges or to waive or eliminate deferred sales charges once the decision to convert or merge the MF has

been made. In a merger, the terms of the merger agreements can include provisions that give MF shareholders of each class a number of shares of the ETF that correspond to the net asset value of their MF shares as of the conversion.

- *Treatment of Direct Shareholders.* Unlike ETF shares, which are held through brokerage accounts,²¹ some MF shareholders hold their shares directly with the MF's transfer agent. MF shareholders will need to establish a brokerage account (with a broker that is a Depository Trust & Clearing Corporation (DTC) member) in order to buy and sell ETF shares after the conversion. Prior to the conversion, the sponsor may wish to identify accounts for which there is no designated broker-dealer, and work with affected MF shareholders to establish brokerage accounts. Sponsors may wish to assist these MF shareholders by establishing a mechanism for these shareholders to open brokerage accounts conveniently (perhaps on favorable terms) with select brokerage firm partners. If no brokerage account is established, ETF shares may be held in a transfer agent account until a brokerage account is established or the shares are involuntarily redeemed for cash (if permitted). Regardless of the path chosen by the sponsor, thoughtful and helpful shareholder communications will be key to successfully transitioning MF shareholders to an ETF environment.

Efforts to engage with certain MF shareholders may prove especially challenging, including retirement plans and individual retirement accounts (IRAs), for which additional considerations may apply. Often, the MF interfaces primarily with a third party, such as a retirement plan administrator, in these arrangements. Before deciding to pursue a MF-to-ETF conversion, sponsors may wish to consider the MF's shareholder makeup and account breakdown to understand the scope of the required effort.

- *Fractional Shares.* Unlike MFs, ETFs typically do not issue fractional shares.²² For a direct conversion, any existing fractional shares of the MF may need to be redeemed prior to the conversion. For a merger, the terms of the merger may need to provide for the redemption of fractional ETF shares that would otherwise have been issued in the merger.²³ The redemption of fractional shares would likely be treated as a taxable event to affected shareholders. Where shares are held in omnibus or DTC accounts, the MF will need to work with the top-level account holders to identify and redeem underlying fractional share positions in the omnibus and DTC accounts.
- *Adjusting the Portfolio.* The Semi-Transparent Active ETF's exemptive order will limit the ability of the Semi-Transparent Active ETF to invest in instruments other than exchange-listed equities and other instruments that trade contemporaneously with the ETF shares. A MF that holds investments that are not permitted under the relevant order (for example, bonds, foreign securities, currencies, short positions, etc.) will need to divest any such investments before a direct conversion or merger, which may require careful planning to minimize transaction costs and adverse tax consequences. In a direct conversion, corresponding changes to the MF's principal investment strategies and investment restrictions will need to be effected to reflect the restrictions on the Semi-Transparent Active ETF's investments and operations and permit the Semi-Transparent Active ETF to rely on the order; in a merger, the Semi-Transparent Active ETF's initial registration statement would reflect the investment restrictions applicable under the order.

In a merger or asset sale, certain assets may not be eligible to be transferred in kind (for example, certain types of derivatives or non-US securities of certain countries), so the MF may have to sell those assets for cash prior to

the transaction. This may result in adverse tax consequences, and the MF may have to incur transaction costs. Further, the ETF may incur transaction costs in reacquiring similar assets. If the impact of such transactions is expected to be significant, a sponsor may wish to consider utilizing a direct conversion rather than a merger or asset sale as a way of avoiding these potential tax consequences or transaction costs.

- *MF Performance Track Record.* Based on existing no-action relief, the ETF should be able to use the converting MF's performance history.²⁴ Care should be taken to consider whether to disclose the potential effects of strategy changes effected as part of the conversion on the relevance of the historical performance information shown. Because ETFs often present performance based on NAV and on market price, the ETF may wish to include disclosure to the effect that the prior performance was based on the NAV per share of the MF shares rather than on market-determined prices.

Tax Considerations

The conversion of a MF to an ETF should in itself not have any significant, negative tax consequences to the MF or its shareholders. As discussed above, the ETF structure generally provides tax benefits to investors. However, given the unique nature of Semi-Transparent Active ETFs, there may be additional tax considerations or limitations relevant to such ETFs under the Internal Revenue Code of 1986, as amended (Code). For example, to ensure that a Precidian model ETF's in-kind transactions with the AP through the AP representatives are respected for tax purposes, an ETF may need to take steps to ensure that the AP representative is not treated as an agent of the ETF when selling securities received from the ETF. Sponsors should consult with their tax counsel to ensure that the tax implications of their specific conversion plans and the resulting ETF are

understood. Some of the key factors relevant in evaluating the tax consequences of the MF-ETF conversion are summarized below:

- *Direct Conversion.* A direct conversion itself generally should not result in any tax consequences for the Fund or its shareholders. However, if fractional shares were exchanged for cash in connection with the direct conversion, such exchange to cash would be treated as a taxable event to the shareholders.
- *Merger.* The factors that will determine whether a merger between a MF and an ETF represents a tax-free reorganization generally will be the same as those with respect to the merger of two MFs. Generally, the merger is not taxable to the MF, the ETF or shareholders if it qualifies as a tax-free reorganization under the Code, except to the extent that fractional shares are exchanged for cash. For mergers into an ETF that has not commenced investment operations at the time of the merger, the transaction may meet the requirements of an “F” reorganization,²⁵ including that the ETF not have issued shares or held property prior to the merger (except for seed amounts necessary to form the ETF) and that the ETF assume all the liabilities of the MF. An “F” reorganization is a type of tax-free reorganization in which the ETF would be treated as a continuation of the MF for income tax purposes, such that the ETF keeps the employer identification number (EIN) or Tax ID of the MF and the merger does not close the taxable year of the MF.
- *Disposition of Securities.* A disposition of securities prior to the conversion, whether a direct conversion or merger, may result in the recognition of capital gain, which would be required to be distributed to shareholders in taxable distributions. As noted above, in certain circumstances, such as when non-US securities are unable to be transferred in kind, a direct conversion may be preferable to a merger or asset sale if the tax

consequences and transaction costs associated with the disposition (and potential reacquisition) of securities is significant.

Other Important Considerations

In addition to the points outlined above, a conversion from a MF into an ETF will raise a variety of additional operational, business, and compliance considerations:

- *Distribution.* Because the distribution models for MFs and ETFs differ significantly, sponsors should engage with distribution partners to ensure a smooth transition for investors. This may include entering into new or modified sales arrangements with distribution partners. This also may involve training sales staff regarding the differences between MFs and ETFs and hiring an ETF capital markets specialist to engage with APs, market makers and other market participants.
- *Creation and Redemption Process.* The ETF creation and redemption process differs from the MF portfolio management process. Portfolio managers will have to understand the differences in processes and be ready to manage the creation and redemption process immediately following conversion. In addition, it will be necessary to establish a creation and redemption infrastructure for the ETFs. This will involve establishing relationships with APs and market makers, preparing an AP agreement, preparing creation/redemption order guidelines, and compliance policies and procedures, including ETF basket construction policies.
- *Custom Baskets.* ETFs operating under the ETF Rule are permitted to engage in custom basket transactions, which allow for greater flexibility in selecting securities to meet redemption requests. While certain Semi-Transparent Active ETFs have obtained similar flexibility,²⁶ not all Semi-Transparent Active ETFs have the ability

to use custom baskets. If the ETF in the conversion transaction is able to utilize custom baskets, the ETF will have to adopt basket construction and custom basket policies and procedures and maintain certain records as required by the ETF Rule and/or any exemptive relief.

- *Availability of APs and AP Representatives.* As the models for Semi-Transparent Active ETFs are relatively new, a robust infrastructure may not always be available to facilitate trading in the ETF shares.
- *Regulation Fair Disclosure.* The Semi-Transparent Active ETF applications make Semi-Transparent Active ETFs subject to certain provisions of Regulation FD, which generally requires the implementation of procedures to prevent selective disclosure of portfolio holdings information.

Guinness Atkinson: A Mutual Fund-to-ETF Conversion Case Study

On May 22, 2020, Guinness Atkinson announced that it would seek to convert two of its MFs into ETFs.²⁷ The transactions were completed on March 26, 2021, with the new ETFs opening for trading on March 29, 2021.²⁸ The process from announcement to consummation was a long one, with Guinness Atkinson making several SEC filings on Form N-14. On September 21, 2020, Guinness Atkinson filed a prospectus/information statement on Form N-14 describing its plans for the conversion of its Guinness Atkinson Asia Pacific Dividend Builder Fund and Guinness Atkinson Dividend Builder Fund to ETFs via mergers.²⁹ Guinness Atkinson amended its SEC filing on November 12, 2020 to provide further information regarding the proposed conversions.³⁰ On March 1, 2021, Guinness Atkinson's N-14 was declared effective by the SEC,³¹ and the transactions were officially underway.

Key features highlighted in the Guinness Atkinson N-14 include:

- *Directly Held Accounts.* The N-14 urged shareholders who hold their shares directly with the Fund's transfer agent to open a brokerage account and have their existing fund shares transferred into that account. The N-14 provided step-by-step instructions to do so, but did not suggest or name any particular broker with whom the funds have partnered. The N-14 also offered the option to exchange into other Guinness Atkinson funds before the reorganization. Those direct shareholders who took no action before the reorganization had their shares converted in the reorganization, but the shares are held by a stock transfer agent who will await instructions from the shareholder.
- *Fractional Shares.* If a shareholder's broker was unable to accommodate fractional shares, any fractional shares were redeemed in cash as part of the reorganization. Given that MF shares are often held in omnibus and DTC accounts, Guinness Atkinson reported that the elimination of fractional shares was more complex than anticipated, as the MFs had to work with the top-level account holders to identify and redeem underlying fractional share positions in omnibus and DTC accounts.³²
- *Portfolio Repositioning.* The resulting ETFs rely on the ETF Rule, so are not subject to the portfolio holdings limitations that apply to Semi-Transparent Active ETFs. However, one of the ETFs held securities in a foreign jurisdiction that does not permit the in-kind transfer of securities, so the ETF had to re-establish the positions after the reorganization.
- *Operation as an ETF.* The N-14 included extensive disclosure regarding the differences between MFs and ETFs, including the differences in the makeup of an ETF's expenses and the manner of an ETF's operations.
- *Other Business Considerations.* The fund sponsor lowered the expense caps for each of the involved funds, in one case significantly (1.10 percent to

0.78 percent). The fund sponsor also absorbed all costs of the reorganization.

Other ETF conversions have been announced, with several from Dimensional slated to be completed in June 2021.

Conclusion

After years of wondering whether a MF to ETF conversion was possible, driven largely by the SEC's rejection of Huntington's proposal in 2012, the asset management industry continued to hold out hope for such conversions. Now that Guinness Atkinson has successfully converted two of its MFs to ETFs, other sponsors may be giving conversions more serious consideration.

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NOTES

- ¹ Brian McCabe, *et al.*, "Converting Traditional Open-End Funds into ETFs," *The Inv. Law.*, Vol. 26, No. 7 (July 2019), <https://www.ropesgray.com/-/media/Files/articles/2019/07/IL0719Brian-D-McCabeLarssonSax.pdf>.
- ² See Claire Ballentine, "History Made as First Mutual Fund Converts Into an ETF," *Bloomberg.com* (March 29, 2021, 4:18 AM) (<https://www.bloomberg.com/news/articles/2021-03-29/history-made-as-first-mutual-fund-formally-converts-into-an-etf>) (Guinness Atkinson Funds, Form N-14 (Sept. 21, 2020), https://www.sec.gov/Archives/edgar/data/919160/000139834420018901/fp0057860_n14.htm)). Several other fund sponsors have taken steps to convert MFs into ETFs. See Starboard Investment Trust, Prospectus Supplement (Oct. 29, 2020), <https://www.sec.gov/Archives/edgar/data/1464413/000146441320000186/>

[r497e8631020.htm](https://seekingalpha.com/news/3674269-cannabis-investors-might-see-another-etf) (proposed Starboard conversion); <https://seekingalpha.com/news/3674269-cannabis-investors-might-see-another-etf> (proposed Foothill conversion). In addition, *Dimensional Fund Advisers has announced its intention to convert several tax-advantaged mutual funds to ETFs*. See "Dimensional Fund Advisers Significantly Expands ETF Offering," *Yahoo.com* (Nov. 17, 2020 6:22 AM), <https://finance.yahoo.com/news/dimensional-fund-advisors-significantly-expands-112200333.html>; Katherine Greifeld, "David Booth's DFA Starts Clock on Landmark \$26 Billion ETF Shift," *Bloomberg.com* (Mar. 2, 2021, 8:02 AM) <https://www.bloomberg.com/news/articles/2021-03-04/david-booth-s-dfa-starts-clock-on-landmark-26-billion-etf-shift>. The Starboard conversion was completed in May. See Nottingham Leads Revolutionary Mutual Fund to ETF Conversion, <https://www.prnewswire.com/news-releases/nottingham-leads-revolutionary-mutual-fund-to-etf-conversion-301290690.html> (May 13, 2021).

- ³ See, e.g., Jessica Toonkel, "SEC Rejects Huntington's Request to Convert Fund to ETF," *Reuters.com* (June 20, 2012, 5:32 PM), <https://www.reuters.com/article/us-huntington-etf/sec-rejects-huntingtons-request-to-convert-fund-to-etf-idUSBRE85J1JS20120620>. While the first MF to ETF conversions have only recently been completed, MFs have previously converted into closed-end funds that were traded on an exchange. See the related Ropes & Gray Alert, "Unusual Conversion of a Mutual Fund to a Closed-End Fund," Ropes & Gray LLP (Nov. 30, 2017), <https://www.ropesgray.com/en/newsroom/alerts/2017/11/Conversion-of-a-Mutual-Fund-to-a-Closed-End-Fund>. Closed-end funds have also converted into ETFs in the past (see Bloomberg, "Closed-end Fund Converts into ETF Format," *InvestmentNews.com* (June 18, 2007), <https://www.investmentnews.com/closed-end-fund-converts-into-etf-format-9722>), and ETFs have been converted into MFs (<https://seekingalpha.com/article/2118103-this-wasnt-supposed-to-happen-etf-converts-to-mutual-fund>) and merged into ETF shells (iShares MSCI Russia Capped ETF, Inc., Proxy

Statement (Form DEFA14A) (Nov. 12, 2014), <https://sec.report/Document/0001193125-14-406494/d819313ddefa14a.htm>).

⁴ *Exchange-Traded Funds*, Release Nos. 33-10695; IC-33646 (Sept. 25, 2019), <https://www.sec.gov/rules/final/2019/33-10695.pdf> (the Adopting Release).

The ETF Rule is discussed in a separate Ropes & Gray Alert. Edward Baer *et al.*, “2019 Final ETF Rulemaking – Summary and Analysis,” Ropes & Gray LLP (Oct. 15, 2019), <https://www.ropesgray.com/en/newsroom/alerts/2019/10/2019-Final-ETF-Rulemaking-Summary-and-Analysis>.

⁵ See Precidian ETFs Trust, *et al.* (File No. 812-14405), Inv. Co. Act Rel. Nos. 33440 (Apr. 8, 2019) (notice) and 33477 (May 20, 2019) (order), https://www.sec.gov/Archives/edgar/data/1396289/000114420419018151/tv518160_40-appa.htm (Precidian); T. Rowe Price Associates, Inc. *et al.* (File No. 812-14214; Inv. Co. Act Rel. Nos. 33685 (Nov. 14, 2019) (notice) and 33713 (Dec. 10, 2020) (order), <https://www.sec.gov/Archives/edgar/data/80255/000119312519268669/d820681d40-appa.htm> (T. Rowe); Fidelity Beach Street Trust *et al.* (File No. 812-14364) Inv. Co. Act Rel. Nos. 33683 (Nov. 14, 2019) (notice) and 33712 (Dec. 10, 2020) (order), <https://www.sec.gov/Archives/edgar/data/35336/000119312519287794/d829357d40-appa.htm> (Fidelity); Blue Tractor ETF Trust *et al.* (File No. 812-14625) Inv. Co. Act Rel. Nos. 33682 (Nov. 14, 2020) (notice) and 33710 (Dec. 10, 2020) (order), <https://www.sec.gov/Archives/edgar/data/1668791/000168035919000611/blu-etractor40-appa10232019.htm> (Blue Tractor); Natixis ETF Trust II, *et al.*, (File No. 812-14870) Inv. Co. Act Rel. Nos. 33684 (Nov. 14, 2020) (notice) and 33711 (Dec. 10, 2019) (order), <https://www.sec.gov/Archives/edgar/data/1018331/000119312519270781/d821264d40-appa.htm> (Natixis/NYSE), and Invesco Capital Management LLC, *et al.*, (File No. 812-15070) Inv. Co. Act Rel. Nos. 34087 (Nov. 6, 2020) (notice) and 34127 (Dec. 2, 2020) (order), <https://www.sec.gov/Archives/edgar/data/205021/000119312520287171/d57268d40-appa.htm> (Invesco). The T. Rowe,

Fidelity, Blue Tractor, Natixis/NYSE and Invesco relief all represent variations on a “proxy portfolio” approach to shielding ETF portfolio holdings. Collectively, T. Rowe, Fidelity, Blue Tractor, Natixis/NYSE and Invesco are referred to as the “Proxy Portfolio Models.”

⁶ The ETF Rule applies to index-based and actively-managed ETFs that publish their portfolio holdings daily. As originally adopted, the ETF Rule excluded leveraged and inverse ETFs even if they provided daily portfolio transparency. However, under newly adopted Rule 18f-4, leveraged and inverse ETFs can operate under the ETF Rule in certain circumstances. See *Use of Derivatives by Registered Investment Companies and Business Development Companies*,” Inv. Co. Act Rel. No. 34084 (Nov. 2, 2020), <https://www.sec.gov/rules/final/2020/ic-34084.pdf>. All of the completed and announced MF to ETF conversions to date have involved transparent ETFs that will rely on the ETF Rule.

⁷ See, e.g., American Century ETF Trust, *et al.* (File No. 812-15035), Inv. Co. Act Rel. Nos. 33590 (Aug 14, 2019) (notice) and 33620 (Sept. 10, 2019) (order), <https://www.sec.gov/Archives/edgar/data/52388/000171060719000034/exemptiveorder5619.htm>; Invesco Capital Management LLC, *et al.* (File No. 812-15141), Inv. Co. Act Rel. Nos. 34041 (Oct. 1, 2020) (notice) and 34076 (Oct. 27, 2020) (order), <https://www.sec.gov/Archives/edgar/data/205021/000168035920000495/invesco-40-appa09302020.htm>.

⁸ The Guinness Atkinson conversion was structured as an asset sale, and the Dimensional and Starboard conversions are expected to be structured as asset sales.

⁹ AP representatives must be unaffiliated with the ETF and its sponsor and arrange creation and redemption transactions between the ETF and its APs on an agency basis.

¹⁰ Fidelity and Blue Tractor have filed amended exemptive applications to permit ETFs that invest in fixed income, currencies and non-US equities, Blue Tractor has filed an amended exemptive application

to permit long/short equity ETFs, and American Century has filed an exemptive application to ETFs that invest in US and non-US equity securities. See Fidelity Breach Trust, Application for an Order (Dec. 16, 2019), <https://www.sec.gov/Archives/edgar/data/35336/000119312519314931/d842423d40app.htm>; Blue Tractor ETF Trust, Application for an Order (Jan. 2, 2020), <https://www.sec.gov/Archives/edgar/data/1668791/000113743920000002/btex-emapp01022020.htm>; Blue Tractor ETF Trust, Application for an Order to Amend a Prior Order (Mar 19, 2021), <https://www.sec.gov/Archives/edgar/data/0001668791/000168035921000067/bluetractor40app03192021.htm>; American Century ETF Trust, Application for an Order (Dec. 10, 2019), <https://www.sec.gov/Archives/edgar/data/0001710607/000171060719000159/exemptiveorder12919.htm>. In February 2021, three sponsors of Semi-Transparent Active ETFs obtained exemptive relief permitting the ETFs to employ custom creation and redemption baskets similar to ETFs that operate under the ETF Rule. See Invesco Capital Management LLC (File No. 812-15182) (Dec. 7, 2020), <https://www.sec.gov/Archives/edgar/data/205021/000119312520311652/d13730d40appa.htm> (Invesco); Natixis Advisors, L.P. (File No. 812-15157) (Dec. 8, 2020), <https://www.sec.gov/Archives/edgar/data/1018331/000119312520312738/d88633d40appa.htm> (Natixis/NYSE); and Blue Tractor ETF Trust (File No. 812-15162) (Jan. 19, 2021), <https://www.sec.gov/Archives/edgar/data/1668791/000113743921000048/br40appamend01192021.htm> (Blue Tractor). In addition, Invesco's original exemptive application filing (<https://www.sec.gov/Archives/edgar/data/102786/000119312519254770/d802828d40app.htm>) included the ability to invest in fixed income, currencies and non-US equities and to utilize custom baskets. Eaton Vance has also filed an exemptive application for a version of a semi-transparent model that has different features than the Precidian and Proxy Portfolio models. See Eaton Vance Exchange-Traded Funds Trust, *et al.* (File No. 812-15003) (Nov. 5, 2020), https://www.sec.gov/Archives/edgar/data/1076598/000121390020035167/ea129376-40appa4_eatonvance.htm.

- Archives/edgar/data/1076598/000121390020035167/ea129376-40appa4_eatonvance.htm*.
- ¹¹ Carmen Germaine, “Non-Transparent ETFs Pass Their First Test—Spreads Are Tight,” *Fin. Times* (Sept. 11, 2020), <https://www.ft.com/content/62605baa-8903-488f-b10d-e7c2914fbb3d>.
 - ¹² The SEC's Office of Investor Advocate has indicated that it will be monitoring these ETFs to evaluate the functioning of their arbitrage mechanisms. See Office of the Investor Advocate, Report on Objectives: Fiscal Year 2021, SEC, <https://www.sec.gov/files/sec-office-investor-advocate-report-on-objectives-fy2021.pdf>.
 - ¹³ The Precidian application expressly contemplates the prospect of fees paid pursuant to Rule 12b-1 under the 1940 Act. Many ETFs have plans adopted pursuant to Rule 12b-1 that provide for no payment. A handful have Rule 12b-1 plans and charge Rule 12b-1 fees, but ETFs typically only use such fees for broad-based marketing rather than to compensate financial intermediaries.
 - ¹⁴ ETF sponsors occasionally make payments such as for platform fees or data. We note, however, that some platforms have indicated that Semi-Transparent Active ETFs will be subject to fees similar to those applicable to MFs. “Schwab Collects Rev Share on Semitransparent ETFs,” *Ignites.com* (Aug. 14, 2020), https://www.ignites.com/c/2848933/353553?referrer_module=searchSubFromIG&highlight=schwab%20etf%20fees.
 - ¹⁵ See Release No. 34-88625; File No. SR-NYSEArca-2019-81 (Apr. 13, 2020), <https://www.sec.gov/rules/sro/nysearca/2020/34-88625.pdf> (NYSE Arca); Release No. 34-88561; File No. SR-NASDAQ-2019-090 (Apr. 30, 2020), <https://www.sec.gov/rules/sro/nasdaq/2020/34-88561.pdf> (Nasdaq); and Release No. 34-88566; File No. SR-CboeBZX-2019-097 (Apr. 6, 2020), <https://www.sec.gov/rules/sro/cboebzx/2020/34-88566.pdf> (CBOE). For ETFs relying on the ETF Rule, the new listing rules eliminate the continuous listing standards and most of the former quantitative listing standards, including issuer diversification, minimum market capitalization and various other

requirements, and also dispense with the requirement that ETFs publish an intraday indicative value (IIV). NYSE Arca submitted proposed rule changes to the SEC that would establish generic listing standards for Semi-Transparent Active ETFs that follow a Proxy Portfolio and Precidian models, but later withdrew those rule proposals. *See* Release No. 34-89874; File No. SR-NYSEArca-2020-77 (Sept. 15, 2020), <https://www.sec.gov/rules/sro/nysearca/2020/34-89874.pdf>; Release No. 34-90104; File No. SR-NYSEArca-2020-84 (Oct. 7, 2020), <https://www.sec.gov/rules/sro/nysearca/2020/34-90104.pdf>.

¹⁶ Rule 19b-4 under the Exchange Act requires any rule change necessary to list and trade a new derivative securities product to be approved by the SEC in advance of listing such product, unless the SEC has approved a self-regulatory organization's (SRO) trading rules, procedures and listing standards for the product class, and the SRO has a surveillance program for that product class. ETFs must obtain SEC approval of a Rule 19b-4 application or rely on an exception to Rule 19b-4.

¹⁷ In addition to the Rule 19b-4 application, the sponsor may need to seek separate relief from the SEC from certain trading rules under the Exchange Act that may apply to secondary market transactions in ETF shares, such as Regulation M and Rule 10b-17(c). The SEC Staff has issued so-called "class relief" from certain of these trading rules, but Semi-Transparent Active ETFs would not necessarily be eligible for this class relief. For ETFs that operate under the ETF Rule, the SEC has issued an order granting relief from various Exchange Act trading rules. *See Order Granting a Conditional Exemption From Exchange Act Section 11(d)(1) and Exchange Act Rules 10b-10, 15c1-5, 15c1-6 and 14e-5 for Certain Exchange Traded Funds*, Release No. 34-87110 (September 25, 2019), <https://www.sec.gov/rules/exorders/2019/34-87110.pdf>. For Semi-Transparent Active ETFs, the SEC issued a no-action letter that appears to provide certain Exchange Act trading relief for Semi-Transparent Active ETFs that utilize a "proxy portfolio" model and that can comply

with the letter's conditions. *See* Fidelity Covington Trust, SEC Staff No-Action Letter (May 19, 2020), <https://www.sec.gov/divisions/marketreg/mr-noaction/2020/fidelity-covington-trust-nal-05-19-2020.pdf> (the Fidelity Letter). In the Fidelity Letter, the Staff indicated that it will not recommend enforcement action if a broker-dealer treats shares of an ETF operating in a substantially identical manner to that of Fidelity's active, semi-transparent ETF as shares of an ETF relying on the ETF Rule for purposes of the relief from Section 11(d)(1) and Rules 10b-10, 15c1-5, and 15c1-6 provided in the Exchange Act Order. Even if they are able to rely on the Fidelity Letter, Semi-Transparent Active ETFs may still need to obtain relief from the SEC under Rule 14e-5. *See, e.g.,* Precidian Exchange-Traded Trust II, SEC Staff No-Action Letter (May 22, 2019), <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/precidian-etf-trust-ii-052219-14e5.htm>; Natixis ETF Trust II, SEC Staff No-Action Letter (Aug. 26, 2020), <https://www.sec.gov/corpfin/natixis-etf-trust-ii-082620>. This uncertainty may lead to additional delays (although many of these steps can occur simultaneously).

¹⁸ In addition, even if shareholder approval is not technically required by operation of law or the MF's or ETF's organizational documents, the Boards of the MF and the ETF may nonetheless determine to seek shareholder approval.

¹⁹ While many ETFs have adopted Rule 12b-1 plans, most ETFs do not actually charge Rule 12b-1 fees.

²⁰ This is the approach that was used by Guinness Atkinson.

²¹ ETF shares are generally held in book-entry form through the Depository Trust & Clearing Corporation (DTC).

²² While ETFs generally do not issue fractional shares, ETFs held by brokers in a dividend reinvestment plan may reflect fractional shares. Further, certain platforms facilitate the purchase of fractional ETF shares, but such "fractional" shares in that instance generally represent bookkeeping done outside of the ETF's books and records.

- ²³ Under the ETF Rule, ETFs operating under the Rule may redeem fractional shares in connection with transactions such as mergers and liquidations. See ETF Rule adopting release at 56 (“We . . . have modified rule 6c-11 to clarify that, on the day of a reorganization, merger, conversion, or liquidation, an ETF may sell or redeem individual shares and is not limited to transacting with authorized participants.”).
- ²⁴ See, e.g., North American Security Trust, SEC Staff No-Action Letter (Oct. 13, 1992), <https://www.sec.gov/divisions/investment/noaction/1994/north-american-security-trust-080594.pdf>.
- ²⁵ An “F” reorganization derives its name from Section 368(a)(1)(F) of the Code, pursuant to which the reorganization is effected.
- ²⁶ See *supra* n.10.
- ²⁷ Guinness Atkinson Funds, Supplement Prospectus (May 22, 2020), https://www.sec.gov/Archives/edgar/data/919160/000139834420011445/fp0054046_497.htm.
- ²⁸ See *supra* n.2.
- ²⁹ Guinness Atkinson Funds, Form N-14 (Sept. 21, 2020) https://www.sec.gov/Archives/edgar/data/919160/000139834420018901/fp0057860_n14.htm.
- ³⁰ Guinness Atkinson Funds, Form N-14 (Nov. 12, 2020), https://www.sec.gov/Archives/edgar/data/919160/000139834420022229/fp0059172_n14a.htm.
- ³¹ See Guinness Atkinson Funds, Notice of Effectiveness (March 1, 2021), https://www.sec.gov/Archives/edgar/data/919160/999999999521000771/xslEFFECTX01/primary_doc.xml, declaring effective the final version of the N-14 that was filed on February 26, 2021 (Guinness Atkinson Funds, Form N-14 (Feb. 26, 2021), https://www.sec.gov/Archives/edgar/data/919160/000139834421005169/fp0062858_n14a.htm).
- ³² See Deborah Fuhr, ETF TV News #68 Jim Atkinson Discusses Converting First US Mutual Funds Into ETFs, <https://www.etftv.net/etf-tv-news-68-jim-atkinson-discusses-converting-first-us-mutual-funds-into-etfs/> (April 6, 2021).

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