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## Preparing for ETFs as a Share Class: Part I

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This is Part I of a two-part article. This Part I provides background on the Share Class Relief and gives an overview of considerations relevant to a Board's initial consideration of a proposal to launch new share classes in reliance on the Relief. It focuses on the elements required in the "Initial Adviser Report" contemplated by the Relief. Part II, to be published in an upcoming issue of *The Investment Lawyer*, will address considerations relevant to the ongoing monitoring and Board reporting required under the Relief, potential remedial actions a Board may take to mitigate conflicts among share classes, and disclosure requirements. As the Share Class Relief is an evolving topic, Part II also will provide an update on any material changes to the Relief or other significant updates that may transpire after this article has gone to press. As of June 17, 2025, the SEC Staff has suggested that applicants for the Share Class Relief amend their applications to conform to the DFA application amendment that was filed on May 30, 2025. Despite this suggestion, there is no guarantee that there will not be further revisions required by the SEC Staff.

### Introduction

The Securities and Exchange Commission (SEC) is currently considering exemptive relief (Share Class Relief or the Relief) to permit, subject

to conditions described more fully below, a registered open-end mutual fund (Mutual Fund) to offer a class of exchange-traded shares (ETF Shares or ETF Class) and a registered exchange-traded fund (ETF and, together with Mutual Funds, Funds) to offer one or more classes of non-exchange-traded shares with characteristics typical of share classes offered by Mutual Funds (Mutual Fund Shares or Mutual Fund Classes).<sup>1</sup> The Relief would open a new avenue for Mutual Fund sponsors to sell existing publicly offered strategies in an ETF wrapper and ETF sponsors likewise to utilize the Mutual Fund wrapper for existing ETFs, in each case with the ability to use the existing Fund's historical performance record and with lower overall organizational and on-going operating costs than forming and operating separate stand-alone Funds. The more flexible share class structure would enhance investor choice and could provide significant benefits to both Mutual Fund Class and ETF Class shareholders. These benefits would likely include cost savings through economies of scale, reduced shareholder transaction costs, more efficient portfolio management, less disruption from frequent trading by Mutual Fund shareholders, greater arbitrage efficiency and narrower spreads for ETF Shares, and significant tax advantages.

While the SEC has not yet granted the Relief, to date the SEC has received over 50 applications from

Mutual Fund and ETF sponsors across the industry, collectively representing trillions of dollars in Fund assets under management. When granted, the Share Class Relief has the potential to transform the landscape for cost-efficient access to, and distribution of, investment strategies to a broad universe of investors using both Mutual Fund and ETF channels.

This article provides a brief summary of the proposed Share Class Relief and highlights key legal, governance and compliance considerations to guide and inform Funds, their investment advisers (Advisers) and their Boards as they prepare to take advantage of the Share Class Relief. Although the SEC has yet to grant the Share Class Relief<sup>2</sup> and there is no assurance that it ultimately will do so, Fund sponsors may want to move quickly to launch new ETF or Mutual Fund Classes once relief is available. Investing time now in laying the groundwork for these new share class structures could pay dividends by significantly expediting launch. We note that significant operational challenges will need to be addressed before Funds and the industry more broadly will be able to take advantage of the Relief; this article does not address those issues.

## The Share Class Relief

The Share Class Relief is expected to allow a Mutual Fund to offer a class of ETF Shares (in addition to one or more classes of Mutual Fund Shares) and an ETF to offer one or more classes of Mutual Fund Shares (alongside a class of ETF Shares) (we refer to a Fund offering both classes as a “Combined Class Fund” below). As currently contemplated under the Relief, a Combined Class Fund would enjoy the same relief provided by, and be subject to the same conditions contained in, Rule 6c-11 under the Investment Company Act of 1940, as amended (the 1940 Act), with respect to the operation of its ETF Shares. In addition, the Relief will allow Combined Class Funds to offer an exchange privilege that would permit holders of Mutual Fund

Shares to exchange their shares for ETF Shares, but not vice versa except in certain limited circumstances (Exchange Privilege).

While the Share Class Relief would be novel in some respects, it is not without precedent. In particular, in 2000 the SEC granted relief to The Vanguard Group, Inc. (Vanguard) to offer an ETF Class in index Funds, and Vanguard Funds have been operating under that relief (and several related exemptive orders granted in the intervening years) for over two decades.<sup>3</sup> The proposed Share Class Relief would differ from the Vanguard relief in various ways, including that it would apply more broadly to both active and passive strategies.

In recent weeks, the precise form of the Relief has come into sharper focus. On April 1, 2025, Dimensional Fund Advisors LP and its affiliated Funds (DFA) filed with the SEC an amended exemptive application that appeared to reflect significant input from the SEC Staff.<sup>4</sup> Shortly after this filing, the SEC Staff informed other applicants for the Relief that amending their applications to track the DFA application would best position them to receive the Relief should the SEC approve it. While DFA has since made a subsequent amendment to its application (the DFA Application) responding to further SEC Staff comments,<sup>5</sup> the basic framework remains substantially similar. The industry continues to expect that any final exemptive relief will follow the DFA model. Where this article refers to the “Relief,” it assumes that the Relief ultimately issued by the SEC will track the terms of the DFA Application, although the exact terms of the Relief remain, as of the date of this article, a moving target.

The current form of the Share Class Relief includes nearly all of the major substantive features that the industry had hoped for. The Relief will:

1. Allow Mutual Funds to offer an ETF Class and ETFs to offer multiple Mutual Fund Classes;

2. Allow Combined Class Funds to permit shareholders to exchange their Mutual Fund Shares for ETF Shares (Exchange Privilege);<sup>6</sup> and
3. Be available to both actively-managed and index-tracking Funds.<sup>7</sup>

Under the Relief, before a Fund offers both Mutual Fund Classes and an ETF Class, a Board, including a majority of its independent members, must find that the “multi-class structure is in the best interests of each Mutual Fund Class and ETF Class individually and of the Fund as a whole.”<sup>8</sup> Boards will be expected to consider a range of factors in making this determination and will rely on the Fund’s Adviser to provide appropriate information to assist the Board in weighing each factor as it considers making the required “best interests” determination.

In its adopting release for Rule 6c-11 under the 1940 Act the SEC expressed concern that an ETF Class that transacts with Authorized Participants (APs), as defined in Rule 6c-11, on an in-kind basis and a Mutual Fund Class that transacts with shareholders on a cash basis may impose differential costs on the Fund.<sup>9</sup> That is, since Mutual Fund Class shareholders typically transact in cash, while ETF Class shareholders typically transact in-kind, a Fund may need to buy (or sell) portfolio securities to process Mutual Fund Class purchases and redemptions, incurring transaction costs and experiencing tax consequences that would be borne by all shareholders.<sup>10</sup> In addition, a Fund offering both types of shares may need to hold more cash (or other highly liquid assets) than a stand-alone ETF (or otherwise maintain a credit facility and incur related costs) to address the potential for daily redemptions from a Mutual Fund Class. The impacts to the Fund of holding additional cash or low-yield liquid assets (cash drag) would be borne

by all Fund shareholders (including holders of ETF Shares).

These and other concerns related to conflicts of interest between different classes of shares give rise to a number of specific areas that will require analysis by an Adviser and consideration by the Board in connection with an Adviser proposing, and a Board approving, a new share class launch in reliance on the Relief.<sup>11</sup> In particular, the Relief requires that an Adviser:

1. Prepare an initial report to the Board in connection with its approval of a combined class structure (Initial Adviser Report);
2. Implement an ongoing monitoring process relating to the structure (Ongoing Monitoring Process), including establishing appropriate numerical thresholds; and
3. Provide periodic (at least annual) reporting to the Board relating to the results of the Adviser’s Ongoing Monitoring Process (Periodic Adviser Report).

As noted above, this article is being published in two parts. The remainder of this Part I will discuss the Initial Adviser Report; Part II of this article (to be published in an upcoming issue) will address the Ongoing Monitoring Process, the Periodic Adviser Report and other significant conditions of the Relief, as well as any updates on the status and shape of the Relief through the publication date for Part II.

## The Initial Adviser Report

The table below outlines the required elements of the Initial Adviser Report. The categories listed in the left column are those expressly referenced in the Relief as required elements of the report; the right column includes our commentary on how each of those elements might be addressed in the report.

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<p><b><i>1. Description of the sources of potential cost savings and other benefits of a Combined Class Structure</i></b></p>	<p>Cost savings and other benefits under a Combined Class Structure may come from a variety of sources, including economies of scale, the advantages of utilizing a single fund structure, and the unique features of the ETF Class operations.</p> <p><i>Economies of Scale:</i></p> <ul style="list-style-type: none"> <li>• Advisers should estimate the size of the potential market opportunity, and provide net sales projections, for a new ETF Class or Mutual Fund Class(es) and estimate potential reductions in certain fixed costs if the Fund is able to grow to meet these projections.<sup>12</sup> <ul style="list-style-type: none"> <li>○ In assessing the market opportunity, an important consideration will be whether the Fund will have access to new distribution channels for ETF or Mutual Fund Shares and how this access may help the Fund grow.</li> <li>○ Adding an ETF Class may provide access to the self-directed individual retail channel and to clients of registered investment advisers who prefer to utilize ETFs. Many model portfolios, for example, feature ETFs.</li> <li>○ Adding a Mutual Fund Class may help a Fund access the retirement or “401(k)” distribution channel.</li> <li>○ If there are existing breakpoints in advisory or other fees, the analysis of any scale benefits of the new share classes should include the effects of such breakpoints.</li> </ul> </li> <li>• Advisers might also assess the potential advantages or disadvantages of offering both a Mutual Fund Class and an ETF Class of a Fund through the same distribution platforms.</li> <li>• While some platforms that have been reluctant to offer a “clone” Fund (based, in part, on concerns under applicable regulatory standards of conduct<sup>13</sup>) might be open to adding an additional share class, others may question whether continuing to offer a Mutual Fund Class, for example, is advisable when an ETF Class is available.</li> <li>• Consider whether the Fund in question has a marketable track record that could make it easier and faster for a new share class to attract investors and achieve scale. This factor might be particularly relevant for ETF Classes included in model portfolios.</li> <li>• Investigate whether a newly formed Fund would have the same access to relevant distribution platforms and ability to attract investors and achieve scale without its own track record and without the scale of an existing Fund.</li> </ul> <p><i>Benefits of a single fund structure:</i></p> <ul style="list-style-type: none"> <li>• Prepare an estimate of the initial organizational costs of launching a new share class compared to those of creating a new Fund (<i>e.g.</i>, opportunities to piggy-back on existing trading, administration, audit and custody arrangements and to utilize a shared board).</li> </ul>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
	<ul style="list-style-type: none"> <li>• Conduct an analysis of anticipated ongoing expenses associated with maintaining a separate Mutual Fund and ETF versus adding a share class of an existing Fund—<i>e.g.</i>, expenses associated with the preparation and auditing of separate financial statements, separate custodial accounts, separate charges for other services, separate regulatory filings, and other compliance, marketing and distribution and insurance expenses.<sup>14</sup></li> <li>• Assess whether there might be opportunities for reductions in operational risk when managing a single vehicle (<i>e.g.</i>, lower probability of errors in order execution or allocation of investment opportunities than when the same order or opportunity needs to be allocated between a Mutual Fund and an ETF).</li> </ul> <p><i>Operation of the ETF Class:</i></p> <ul style="list-style-type: none"> <li>• Shareholders in the ETF Class transact in individual ETF shares in the secondary market (and not through purchase and redemption transactions with the Fund) while APs in the case of most ETF Classes typically transact with the Fund in-kind (and not in cash) in large blocks of shares (typically 10,000 or more) known as “Creation Units.” <ul style="list-style-type: none"> <li>○ Where a Fund seeks to add an ETF Class, an Adviser should analyze how this feature of the ETF Class may result in lower transaction costs and reduce tax impacts for the Fund.</li> </ul> </li> </ul>
<p><b>2. Description of the impact of reasonably expected cash flows and costs associated with portfolio transactions</b></p>	<ul style="list-style-type: none"> <li>• Assess the extent to which cash inflows and outflows through the Mutual Fund Classes might generate Fund-wide brokerage and trading costs associated with portfolio transactions.</li> <li>• Consider the feasibility of quantifying Fund brokerage and other trading costs on a class-by-class basis after launch or otherwise seeking to distinguish trading that is primarily attributable to cash transactions by Mutual Fund Class investors from trading that is primarily attributable to portfolio management, where practicable.<sup>15</sup></li> <li>• Analyze how net cash inflows and outflows in the Mutual Fund Classes might support (or hinder) portfolio rebalancing or basket creation compared to operating a stand-alone ETF that typically processes only in-kind creations and redemptions.<sup>16</sup></li> <li>• Mutual Funds that have experienced issues with frequent trading could highlight the benefits of making an ETF Class available to existing Mutual Fund shareholders who desire to trade more frequently (or who might want intraday liquidity/pricing), since ETF Class transactions in the secondary market will not result in portfolio transaction costs for the Fund. <ul style="list-style-type: none"> <li>○ Historical data on Mutual Fund shareholder trading behavior (and resultant Fund cash flows) could be helpful for this analysis.</li> </ul> </li> </ul>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
	<ul style="list-style-type: none"> <li>• Gather historical data on a Fund's portfolio turnover rate and identify the sources of that turnover in recent periods. It may be helpful, for example, to attempt to identify to what extent portfolio turnover in recent periods was a result of portfolio rebalancing as opposed to shareholder inflows or outflows.</li> <li>• If available, consider including data on in-kind transactions in an existing Mutual Fund.</li> </ul>
<b>3. Description of the impact of reasonably expected cash levels</b>	<ul style="list-style-type: none"> <li>• Gather data on the Fund's historical cash levels and, in the case of an existing Mutual Fund, to what extent those cash levels were intended to support satisfying shareholder redemption requests.</li> <li>• Evaluate the extent to which having Mutual Fund Classes might cause a Fund to maintain higher cash levels than would a stand-alone ETF (and the extent to which such cash levels can be reduced through use of a credit facility, the cost of which could be allocated only to the Mutual Fund Classes), including the potential impact of cash drag on Fund performance.<sup>17</sup></li> <li>• In connection with the analysis described above, an Adviser may want to consider a Fund's liquidity profile under a liquidity risk management program adopted under Rule 22e-4, the Fund's historical or potential future use of a credit facility, and, for fund-of-fund structures, the Fund's ability to receive prior notice of large redemptions under a fund-of-funds investment agreement under Rule 12d1-4.</li> </ul>
<b>4. Description of the impact of reasonably expected distributable capital gains and, for existing Funds, the extent, and reasonably expected realization, of any unrealized capital gains/losses in light of carry over capital losses</b>	<ul style="list-style-type: none"> <li>• Consider the Adviser's ability to manage the tax impacts of portfolio transactions in response to Mutual Fund Class redemption activity through, among other things, the in-kind redemption process applicable to redemption activity in an ETF Class.<sup>18</sup> <ul style="list-style-type: none"> <li>○ This would also include the ability to minimize realizing capital gains on sales of portfolio securities and to engage in tax-loss harvesting when appropriate across the Fund's portfolio.</li> <li>○ Also consider the availability of existing capital loss carryforwards to offset any realized gains in the future.</li> </ul> </li> <li>• Consider the extent to which in-kind creation and redemption activity in ETF Shares is expected to mitigate or eliminate the realization of capital gains from the sale of positions held by the Fund in connection with the liquidation of portfolio securities to fund cash redemptions.           <ul style="list-style-type: none"> <li>○ For Mutual Funds adding an ETF Class, consider preparing a summary of capital gains distributions over recent periods and an analysis of the extent to which similar gains might be avoided or lessened in the future with the addition of an ETF Class.</li> </ul> </li> </ul>



Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
	<ul style="list-style-type: none"> <li>• Also consider any potential negative tax impacts to holders of the ETF Class from the existence of the Mutual Fund Class (<i>e.g.</i>, realization of capital gains driven by Mutual Fund Class redemption activity the effects of which would be shared by ETF Class shareholders if tax efficiencies of the ETF Class are not sufficient to eliminate all capital gain distributions).</li> <li>• Where an Adviser's proposal will highlight the tax efficiencies of the addition of an ETF Class to an existing Mutual Fund, it may be helpful to review the Fund's existing shareholder base (to the extent such information is available) to identify the current mix of taxable and non-taxable shareholders in the Fund (as the non-taxable shareholders would not experience the same benefit from a more efficient tax structure).</li> </ul>
<p><b><i>5. Discussion of how the Adviser intends to manage the reasonably expected costs associated with the transition to a Combined Class Structure</i></b></p>	<ul style="list-style-type: none"> <li>• Potential fund expenses in connection with transitioning to a Combined Class Structure may include (among others) (i) legal expenses associated with the exemptive application process and preparing amendments to Fund organizational documents, policies and procedures, a Fund's 18f-3 plan, registration statement and agreements with third parties (intermediary and selling platforms, APs, lead market makers, fund administrators and transfer agents), (ii) exchange listing fees (where an ETF Class is being added), (iii) set-up fees with financial intermediaries and/or fund transfer agents.<sup>19</sup> <ul style="list-style-type: none"> <li>○ Advisers may consider absorbing a portion of these costs, though a Board may reasonably determine that a Fund could bear some or all of these costs.</li> </ul> </li> <li>• In assessing potential costs in connection with launching a new class, Funds will need to carefully review their governing documents (including corporate charters, declarations of trust, or limited liability company agreements) to determine whether those documents permit offering Mutual Fund and ETF Classes within the same Fund and, if not, whether amending those documents to accommodate the structure would require seeking shareholder approval. Funds should determine early in the process whether shareholder approval is required to make any necessary amendments to the governing documents and consider the costs of obtaining such approval.<sup>20</sup></li> <li>• Certain costs may be higher in the initial periods after launching a Combined Class Structure. See Section IV.1.C below for considerations relevant to the Fund's scaling-up period when implementing a Combined Class Structure.</li> </ul>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<p><b>6. Discussion of the appropriateness of the Fund's investment strategy for a Combined Class Structure</b></p>	<ul style="list-style-type: none"> <li>Assess whether a Fund's strategy may be subject to capacity constraints and how those constraints might be managed as the Fund grows. <ul style="list-style-type: none"> <li>For Mutual Funds launching an ETF Class, assess how capacity constraints will be managed given that, unlike Mutual Funds, an ETF cannot ordinarily reject purchase orders when the Fund nears capacity.<sup>21</sup></li> <li>For ETFs launching a Mutual Fund Class, consider whether a strategy's potential capacity constraints might have a negative impact on the ability of the ETF arbitrage mechanism to function properly.<sup>22</sup></li> <li>Consider whether existing investment strategies could, consistent with the best interests of existing shareholders, be modified to address potential capacity issues, if necessary.</li> </ul> </li> <li>For a Mutual Fund considering offering an ETF Class, consider whether daily portfolio transparency is compatible with the Fund's investment strategy.<sup>23</sup></li> </ul>
<p><b>7. Discussion of any other potential material conflicts of interest, including any other sources of potential cross-subsidization, identified by the Adviser as being associated with operating a Combined Class Fund</b></p>	<p><i>Existing Transaction Fees:</i></p> <ul style="list-style-type: none"> <li>If an existing ETF imposes a variable fee for cash baskets, consider how this practice might affect the analysis of cross-subsidization when a Mutual Fund Class is added to the Fund.<sup>24</sup></li> <li>Where an existing Mutual Fund charges a purchase or redemption fee, consider whether the fee is sufficient to offset the costs to the Fund of transactions in Mutual Fund Shares.</li> </ul> <p><i>Different Dividend Payment Dates:</i></p> <ul style="list-style-type: none"> <li>Although Mutual Fund Shares and ETF Shares both pay cash dividends, the cash payment date for Mutual Fund Shares will generally be one or more business days before the cash payment date for ETF Shares. To avoid a potential conflict from the situation where the dividends to be paid to the ETF Class remain invested for the benefit of the entire Combined Class Fund, the Relief requires that cash held to pay dividends to ETF Class shareholders be held in a custodial account and not be invested outside of participation in cash sweep vehicles (including money market funds), custodial credit earning programs, or interest bearing accounts. Earnings on such cash held is likely to be negligible.<sup>25</sup></li> <li>With respect to dividend reinvestment, shareholders in the Mutual Fund Class who wish to reinvest their dividends will be able to do so on the ex-dividend date, while shareholders in the ETF Class who wish to reinvest their dividends will not be able to reinvest their dividends until several days later.</li> </ul>



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	<ul style="list-style-type: none"> <li>○ As a result of the difference in when dividends are paid and received for reinvestment, Mutual Fund Class shareholders who reinvest dividends will be continuously invested, while ETF Class shareholders who reinvest will be “out of the market” for several days with respect to the amount of the dividend. An Adviser should attempt to estimate how this difference will affect the relative performance of the classes. We note that ETFs do not typically provide a dividend reinvestment option (although certain brokers may offer a reinvestment option).</li> </ul> <p><i>Differences in Servicing Costs:</i></p> <ul style="list-style-type: none"> <li>• Consider the feasibility of allocating any material servicing costs that are incurred differently by ETF Shares and Mutual Fund Shares separately to such shares. <ul style="list-style-type: none"> <li>○ For example, ETFs typically pay little or no transfer agency, sub-transfer agency, networking or shareholder servicing fees as ETF shares are likely to be held in street name omnibus accounts maintained by brokers and other financial intermediaries to facilitate trading on the exchange.<sup>26</sup> Unlike mutual funds, ETFs typically pay initial listing fees to the exchange and annual fees to maintain the listing, and may pay (or their Advisers may pay) market-maker incentive fees.</li> <li>○ It may be reasonable to allocate transfer agency, sub-transfer agency, networking and shareholder servicing fees only to Mutual Fund Classes where holders of ETF Shares may not directly benefit from these services. Similarly, it may be reasonable to allocate exchange listing fees and market-maker incentive fees only to a Fund’s ETF Class given that only ETF Shares will be listed on the exchange.</li> </ul> </li> <li>• ETFs have historically operated under a unitary fee structure. Advisers may wish to consider whether a unitary fee structure remains appropriate when a Fund has both an ETF Class and one or more Mutual Fund Classes. <ul style="list-style-type: none"> <li>○ A unitary fee charged to only one class in a multi-class structure may present challenges under Rule 18f-3. We believe, however, that it may be consistent with Rule 18f-3 to charge a common advisory fee across the Fund, while charging different administration fees to different Classes.<sup>27</sup> This may require the Board to determine the appropriate “split” between the advisory portion of a unitary fee, and the portion for administrative and other services, which may require careful analysis of the services provided by the Adviser, the third-party services paid for by the Adviser, and other factors.</li> </ul> </li> </ul>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
	<ul style="list-style-type: none"> <li>• We expect that some Advisers, faced with the choice of proposing a traditional Mutual Fund fee structure or a unitary fee structure across all classes, will select a traditional fee structure, given that certain expenses (such as 12b-1 fees and sub-transfer agency fees) should be expected to vary by class. Applying a unitary fee structure across multiple classes could involve meaningful complexity and risk, and the benefits of a unitary fee may be less compelling for Funds that have already achieved scale (since the unitary fee has historically functioned, in essence, as an expense cap).</li> <li>• For Mutual Funds, the addition of an ETF Class will mean that a class of Fund shares will be available for short-selling, margining, lending, borrowing and pledging.</li> <li>• To the extent ETF Shares trade at a market price that reflects a premium or discount to net asset value (“NAV”) or is subject to a bid-ask spread, such trading may impact purchases and sales of Mutual Fund Classes.</li> </ul>

In approving a new Mutual Fund or ETF Class in a Combined Class Structure, the Board will be required to determine, based in part on all of the factors discussed above, that the structure is in the best interests of each Mutual Fund Class and the ETF Class individually and of the Fund as a whole. While some of the discussion above assumes that the appropriate point of comparison may be a similarly-managed stand-alone Fund, it is worth noting that, in many cases, absent the ability to offer a certain strategy as a share class of an existing Fund, a Fund sponsor might not be willing or able to make the share class in question available to the public at all. Thus, in many cases, data points comparing a new share class in a Combined Class Structure to a hypothetical stand-alone Mutual Fund or ETF may not paint a complete picture when determining whether the proposed share class is in the best interests of the Fund or a Class.

## Conclusion

This Part I has focused on issues relevant at the initial stages of proposing new Mutual Fund Classes or an ETF Class in a Combined Class Structure.

Part II of this article, to be published in a future issue, will address important considerations in connection with the ongoing operation of a Combined Class Structure. Part II will discuss the Ongoing Monitoring Process and the Periodic Adviser Report and address some thorny issues associated with determining appropriate “numerical thresholds” relating to portfolio transaction costs, cash levels and capital gains, as required under the Relief. Part II also will summarize other significant conditions of the Relief (including disclosure requirements) and flag some issues that may be novel for Mutual Fund sponsors relying on the Relief to launch an ETF Class for the first time. Part II also will provide an update on the status and shape of the (still evolving) Relief as of the publication date for Part II.

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## NOTES

- <sup>1</sup> On March 17, 2025, Ropes & Gray published a white paper describing the much anticipated Relief and outlining matters we believed Advisers and Boards may want to consider in connection with their initial implementation of a Combined Class Structure and their ongoing monitoring of such a structure. See, [https://www.ropesgray.com/-/media/files/alerts/2025/03/20250318\\_share\\_class\\_structures\\_mutual\\_funds\\_white\\_paper.pdf?rev=4f84402e520e4c70954ebfa61397bed2&hash=C95561CECBE44042384B1026AF04147E](https://www.ropesgray.com/-/media/files/alerts/2025/03/20250318_share_class_structures_mutual_funds_white_paper.pdf?rev=4f84402e520e4c70954ebfa61397bed2&hash=C95561CECBE44042384B1026AF04147E).
- <sup>2</sup> As noted, *infra* n.3, the Vanguard Group, Inc. obtained a form of Share Class Relief in 2000.
- <sup>3</sup> *Vanguard Index Funds*, Investment Company Act Release Nos. 24680 (Oct. 6, 2000) (notice) and 24789 (Dec. 12, 2000) (order); *The Vanguard Group, Inc.*, Investment Company Act Release Nos. 26282 (Dec. 2, 2003) (notice) and 26317 (Dec. 30, 2003) (order); *Vanguard International Equity Index Funds*, Investment Company Act Release Nos. 26246 (Nov. 3, 2003) (notice) and 26281 (Dec. 1, 2003) (order); *Vanguard Bond Index Funds*, Investment Company Act Release Nos. 27750 (Mar. 9, 2007) (notice) and 27773 (April 2, 2007) (order). We note that the vast majority of Vanguard ETF assets under management are attributable to ETF Share Classes of Funds that also offer a Mutual Fund Class, rather than stand-alone ETFs. Until recently, Vanguard held a patent on this share class structure. It has been reported that this patent protection expired in May of 2023. While we understand that several firms have licensed the structure from Vanguard and applied for similar relief over the years, the SEC declined to grant relief. See, e.g., <https://www.sec.gov/Archives/edgar/data/732910/000119312516594242/d183837d40appa.htm>.
- <sup>4</sup> See Dimensional Fund Advisors LP, *et al.*, SEC File No. 812-15484 (Apr. 1, 2025) (amended application).
- <sup>5</sup> See Dimensional Fund Advisors LP, *et al.*, SEC File No. 812-15484 (May 30, 2025) (amended application).
- <sup>6</sup> The Relief provides that the Exchange Privilege would not permit shareholders of ETF Shares to exchange such shares for Mutual Fund Shares, except in situations where the ETF Class is terminated or where the Combined Class Fund merges into a Fund with no ETF Class.
- <sup>7</sup> The Relief is not, however, expected to extend to semi-transparent active ETFs.
- <sup>8</sup> Mutual Fund Boards will be familiar with this standard as it mirrors the standard that has long been applicable to the approval of a multi-class plan pursuant to Rule 18f-3 under the 1940 Act. See Rule 18f-3(d).
- <sup>9</sup> See *Exchange-Traded Funds*, SEC Release Nos. 33-10695; IC-33646 (available at <https://www.sec.gov/files/rules/final/2019/33-10695.pdf>) (Rule 6c-11 Adopting Release), at footnote 425: “These costs [resulting from combined class structure] can include brokerage and other costs associated with buying and selling portfolio securities in response to mutual fund share class cash inflows and outflows, cash drag associated with holding the cash necessary to satisfy mutual fund share class redemptions, and distributable capital gains associated with portfolio transactions.” For the sake of simplicity, this article generally assumes that transactions in Mutual Fund Shares are effected in cash, and that creation or redemption transactions involving ETF Shares with the Fund are effected in kind. While this will not always be the case, the considerations outlined below come into sharper relief when set against the background of this basic structural difference between the Mutual Fund and ETF Classes.
- <sup>10</sup> As the SEC noted in the Rule 6c-11 Adopting Release, these costs, which typically would not be borne by the Fund (or would be offset by variable fees paid by APs for cash-in-lieu of in-kind securities) with respect to transactions in ETF Shares, may include brokerage and execution costs, but also, in some cases, the second-order impacts associated with the realization of capital gains when an appreciated security is sold (which could result in distributions

to shareholders, given a Fund's distribution requirements as a regulated investment company).

<sup>11</sup> In preparation for launching a new class in reliance on the Relief, a Fund also will need to carefully consider its public disclosure (including in its prospectus) of the Combined Class Structure, which should inform shareholders of the key differences between Mutual Fund and ETF Classes, and alert them to potential conflicts of interest arising from the Combined Class Structure, as well as the potential disadvantages of holding Mutual Fund or ETF Shares in a Fund that offers both. Part II of this article will summarize the specific disclosure requirements under the Relief.

<sup>12</sup> For Funds adding an Exchange Privilege for one or more existing Mutual Fund Classes, the Adviser and the Board might also consider whether exchanges of Mutual Fund Shares into ETF Shares may negatively impact economies of scale within the Mutual Fund Class. To the extent class-specific expenses are not asset-based, at certain asset levels a class may cease to be viable. Advisers might consider whether and how any such impacts might be mitigated.

<sup>13</sup> Regulation Best Interest under the Securities Exchange Act of 1934 (Reg BI) and the Financial Industry Regulatory Authority (FINRA) suitability rule establish standards of conduct for broker-dealers and their associated persons when they make a recommendation to a customer. A broker-dealer may need to evaluate whether the costs and features of a class offered by a Fund make it suitable for, or in the best interests of, their customer, including relative to other classes offered by the Fund. We note that although the investment returns of the various classes during the period when they are held by an investor will likely differ only by differences in expense ratios, the process for investing in the Fund, and the associated costs and benefits to investors (for example, the possibility that ETF Class Shares will be purchased or sold at a premium or discount to NAV, that an investor may be able to buy or sell ETF Class Shares intraday or that liquidity may not exist in the secondary market at the time that an investor wants to trade in ETF Shares) may have significant implications for an

investor's returns, and therefore whether a particular class is suitable for, or in the best interests of, that investor, relative to other classes offered by the Fund.

<sup>14</sup> Note that expenses attributable only to a certain share class (or classes) could potentially be allocated only to the applicable share class(es).

<sup>15</sup> As noted in our March 17 white paper, there are challenges associated with ongoing monitoring of these costs on a class-by-class basis. Part II of this article will address some of these challenges in the context of determining an appropriate numerical threshold for portfolio transaction costs. Note that although existing Mutual Funds offer a range of share classes that may experience significantly different levels of turnover, we do not observe Mutual Funds attempting to quantify these costs on a class-by-class basis to allay concerns about cross-subsidization within currently existing class structures.

<sup>16</sup> Daily cash flows in a Mutual Fund Class may be particularly helpful for ETFs that rebalance on a more frequent (*e.g.*, daily) basis. These cash flows might also help with portfolio completion in circumstances where a desired security cannot be transferred on an in-kind basis and is therefore not included in the composition of creation baskets generally.

<sup>17</sup> Adding an ETF Class could result in a reduction in a Fund's Highly Liquid Investment Minimum under Rule 22e-4.

<sup>18</sup> When a Mutual Fund transitions to a Combined Class Fund, it will establish new relationships with APs and market makers and may therefore be better positioned to utilize in-kind redemptions in the Mutual Fund Class.

<sup>19</sup> Funds may also need to consider whether revisions will be needed to existing "shareholder information agreements" in place with financial intermediaries pursuant to Rule 22c-2 or existing "fund of funds" investment agreements adopted pursuant to Rule 12d1-4 to reflect the addition of an ETF Class to a Fund. In addition, Advisers will need to review existing Fund and Adviser policies and procedures to determine whether any changes are necessary (for example, policies related to portfolio holdings

disclosure, valuation, liquidity risk management, recordkeeping, identification of affiliated persons, codes of ethics, etc.).

- <sup>20</sup> To the extent a Fund will otherwise be seeking shareholder approval to amend its organizational documents to launch new share classes, the Fund might consider including in that proposal provisions providing for flexibility to spin out, merge or terminate a share class without shareholder approval (to the extent needed and consistent with applicable law) given that one of the remedial measures discussed below might involve such restructurings.
- <sup>21</sup> The SEC has stated that “[a]n ETF that suspends the issuance or redemption of creation units indefinitely could cause a breakdown of the arbitrage mechanism, resulting in significant deviations between market price and NAV per share,” and has, accordingly, taken the view that “an ETF generally may suspend the issuance of creation units only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF’s portfolio holdings are traded are closed for a limited period of time.” See Rule 6c-11 Adopting Release, *supra* n.9 at p.58.
- <sup>22</sup> The “arbitrage mechanism” with respect to an ETF refers to the tendency of trading activity by APs to prevent the market price for ETF Shares from differing materially from the NAV per share of the ETF. When ETF Shares are trading in the secondary market at a price lower than the ETF’s NAV per share, APs have an incentive to purchase ETF Shares in the

secondary market and deliver them to the ETF in exchange for the ETF’s portfolio securities. AP purchases of ETF Shares would tend to increase the price of the ETF Shares until it approaches the ETF’s NAV per share. The process would work in reverse in the event that ETF Shares are trading in the secondary market at a price above the NAV per share of the ETF.

- <sup>23</sup> Where other accounts are managed alongside the Fund according to the same investment strategy, an Adviser may need to assess whether/how the Fund’s level of transparency could result in increased market impact when making trades for the overall strategy.
- <sup>24</sup> ETF variable fees are typically stated as maximums (e.g., up to 3% on creations and up to 2% on redemptions). The amounts actually charged may be more instructive, although these charges are based on different trading sizes.
- <sup>25</sup> Note that the Relief requires that a Combined Class Fund impose restrictions (often in the form of “blackout dates”) on exchanges around the dates of dividend payments if necessary to prevent a shareholder from collecting a dividend from both the Mutual Fund Class and the ETF Class as a result of an exchange of shares.
- <sup>26</sup> We are aware that some wirehouses currently provide what is essentially a sub-transfer agency service for ETF shareholders free of cost, though they may charge for these services in the future.
- <sup>27</sup> Note, however, that custody fee rates would generally need to be the same between an ETF Class and a Mutual Fund Class.

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