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Preparing for ETFs as a Share Class: Part II

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This is Part II of a two-part article. Part I of this article, which appeared in the July 2025 issue of *The Investment Lawyer*, provided background on the Share Class Relief and an overview of issues relevant to a Board's initial consideration of a proposal to launch new share classes in reliance on the Relief. Part I focused on the elements required in the "Initial Adviser Report" contemplated by the Relief. This Part II addresses 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. The Share Class Relief is an evolving topic. Please refer to Part I of this article for additional background and context on the current regulatory status of the Relief. As of the date this Part II was submitted for publication (August 5, 2025), the SEC had not yet granted the Relief (or formally "noticed" any recent application for the Relief). When (and if) it does so, the terms and conditions of the Relief may differ from those described below. Please note that capitalized terms used but not defined in this Part II have the meanings given to them in Part I of this article.

The Ongoing Monitoring Process

The Relief requires that, at the time of the Board's initial approval of a Combined Class

Structure, an Adviser recommend to the Board for approval a framework for monitoring certain metrics intended to assist the Board in its ongoing oversight of the Combined Class Structure. A central aspect of this framework will be specific numerical thresholds relating to (1) costs associated with portfolio transactions, (2) cash levels, and (3) capital gains distributions.¹ An Adviser must recommend, and the Board must approve, a numerical threshold in each of these categories, the time period over which to measure each threshold, and the method for calculating each threshold.

We refer to these three categories (portfolio transaction costs, cash levels and capital gains distributions) collectively below as the "Monitoring Categories." The Monitoring Categories represent key areas in which the operation of Mutual Fund Classes in a Combined Class Fund may impose costs on the Fund's ETF Class. Determining appropriate numerical thresholds will involve challenges along a number of different dimensions including (1) what combination of historical and/or projected data to use; (2) whether/how to account for the impact of market conditions; (3) how to account for unique issues that may be encountered during a new class ramp-up period; and (4) how to weigh the counterbalancing benefits of a Combined Class Structure.

Determining the Numerical Thresholds

The Bigger Picture: Purposes of the Numerical Thresholds

As Advisers and Boards work to develop a methodology for setting appropriate numerical thresholds, they should keep in mind that the Relief does not require that perfect parity be achieved among the Classes. That is, a basic assumption underlying the requirement to identify numerical thresholds is that some differential costs associated solely with the operation of Mutual Fund Classes or an ETF Class may be borne by a Combined Class Fund as a whole. There is of course, some degree of mutuality inherent in all fund structures. A Board must determine, in its business judgment, what level of cost sharing is consistent with a Combined Class Structure being in the best interests of each Class and the Fund as a whole.

It is worth noting that the numerical thresholds are intended to be set at levels that would result in an exceedance in the event that there are material conflicts of interest (including material cross-subsidization) among the classes, but not every exceedance necessarily indicates the existence of material conflicts of interest. Indeed, we expect that there will be exceedances that the Board determines do not warrant changes to the Combined Class Structure, and the Relief contemplates that the Board may determine to take no action with respect to an exceedance. Put another way, the exceedance of a threshold might reasonably be viewed as a “yellow flag,” not a “red flag.” In addition, the Relief contemplates that the numerical thresholds may need to be recalibrated from time to time and, thus, if their initial set-points seem to trigger frequent false alarms, they can be adjusted.

In light of these considerations, as well as the issues discussed further below, one reasonable approach to setting the numerical thresholds might be for an Adviser to project a future state for the Combined Class Fund, operating at scale under normal market conditions. Consistent with the Relief, an Adviser could model the costs in each

of the Monitoring Categories for this hypothetical Combined Class Fund based on historical data for its existing Funds, or other similar Funds in the marketplace, if that data is available.² An Adviser could also reasonably consider the projected benefits of the Combined Class Structure in setting the numerical thresholds.³ The discussion below highlights a few considerations that tend to counsel in favor of this approach.

Historical Data

The Relief contemplates that, in recommending numerical thresholds, an Adviser will consider historical data, either for the proposed Combined Class Fund or other Mutual Funds and/or ETFs managed by the Adviser, “to the extent the Adviser believes such data is relevant.” An Adviser should not, therefore, be constrained by historical data where it believes such data may not provide the most appropriate basis for a given numerical threshold.

The Relief permits an Adviser to consider, in addition to historical data for the existing Fund at issue, other relevant data, including historical data for other Funds managed by the Adviser or, as we suggest above, projected data for the Combined Class Fund operating at scale.⁴ In recommending a numerical threshold, we expect that Advisers will find it sensible to consider a range of data (including projections). If a numerical threshold for an existing Fund were based solely on historical data for that particular Fund, for example, we expect the numerical thresholds would be exceeded more frequently in the case of an existing ETF seeking to launch a new Mutual Fund Class than in the case of an existing Mutual Fund seeking to launch a new ETF Class.⁵ This may lead to a breach of these thresholds on a regular basis, and throughout the life of the Fund, even when the Combined Class Structure is operating as intended.⁶

Likewise, an existing Mutual Fund, operating at scale, that seeks to launch an ETF Class could potentially adopt numerical thresholds that were inappropriately high if the thresholds were based solely on historical data for the Mutual Fund. A Mutual Fund

at scale could be expected, for example, to realize a level of capital gains that is meaningfully higher than a Combined Class Fund would expect to experience when operating at scale under normal market conditions. For new Combined Class Funds, an Adviser could reasonably determine a threshold based on a synthetic analysis of existing Mutual Funds and ETFs (assuming the Adviser currently manages both kinds of Funds or otherwise has access to relevant data for both kinds of Funds).⁷

In short, although historical data for existing Funds often will be relevant, the Relief permits an Adviser and Board to consider all relevant data, including projections for the Combined Class Fund based on reasonable assumptions and good faith estimates. Historical data, in any event, should not be expected to generate a single number with respect to any of the Monitoring Categories. There will be many different methods for analyzing the available historical data, each of which may be chosen in good faith and may produce meaningfully different outputs, potentially representing a broad range. How an Adviser recommends, and a Board approves, a number from that range will, almost inevitably, be informed by factors external to the historical data itself. It is worth noting that a Board will be required to approve, in addition to the numerical thresholds themselves (and time periods over which they are measured), the method for calculating them.

Accounting for the Ramp-Up Period

As suggested by the Relief, an Adviser and a Board may need to be on higher alert for issues of cross-subsidization when new classes are first launched and are gathering assets. For example, where new Mutual Fund Classes are being added to an existing ETF, new cash inflows into the Mutual Fund Classes will need to be invested, potentially resulting in elevated portfolio transaction costs. These expenses may be significant and anomalous if new inflows are large in the initial period after the Mutual Fund Class launch. The portfolio transaction costs of the stand-alone ETF may historically

have been very low, and portfolio transaction costs of the Combined Class Fund may, during this initial period of gathering assets, be meaningfully higher (in basis point terms, if not in absolute dollars) than the level experienced by (1) the existing ETF, (2) a similarly situated Mutual Fund operating at scale, or (3) the Combined Class Fund itself once it reaches scale in the Mutual Fund Class.

Similarly, where an existing Mutual Fund seeks to add an ETF Class, the Combined Class Fund might expect to experience higher levels of portfolio transaction costs during the ramp-up period than when the ETF Class achieves scale. A simple example might help to illustrate this point. Assume a Mutual Fund invests primarily in US equity securities and today incurs, on average under normal market conditions, brokerage expenses equal to 0.02 percent of net assets annually. Where the Fund adds an ETF Class that transacts primarily using in-kind baskets, the addition of the ETF Class would not be expected to result in the Fund incurring material additional brokerage and trading costs. Where brokerage expenses are divided among all Classes on the basis of the NAV of each class, the ETF Class initially would be expected to incur brokerage expenses equal to 0.02 percent of net assets annually, since, when the assets in the ETF Class are *de minimis*, the Fund would be expected to trade its portfolio securities largely in much the same way it did before the addition of the ETF Class. However, as the ETF Class gains assets, adjustments to the Fund's portfolio could increasingly be made through the in-kind creation and redemption process in the ETF Class. As a result, under normal circumstances, brokerage expenses might be expected to decrease.

Where an existing Mutual Fund is adding an ETF Class, issues in other Monitoring Categories may be more pronounced during ramp-up. When the ETF Class is sub-scale, the Combined Class Fund may still exhibit levels of realized gains that are more typical of a Mutual Fund. When the ETF Class achieves scale, however, the Combined Class Fund

may expect to realize relatively lower levels of capital gains by harnessing the in-kind creation and redemption mechanism inherent to the ETF structure.⁸

During the ramp-up period for a new Mutual Fund Class being added to an ETF, it is unlikely that the level of realized capital gains or cash positions would be materially higher than it would be during a Combined Class Fund's steady state when the Mutual Fund Class reaches scale. In fact, it may be lower while the assets in the Mutual Fund Classes are small, as purchase and redemption activity in those classes will have only a marginal impact on the Fund's portfolio trading.

The approach sketched out above (of using a future at-scale Combined Class Fund as the basis for setting the initial numerical thresholds) may, in practice, result in more frequent Board reporting of exceedances during the ramp-up period. The expectation would be that, once scale is achieved across the classes, the numerical thresholds might be less likely to be exceeded, except in periods of significant inflows or outflows of the Mutual Fund Class or under unusual market conditions.

The Impact of Market Events

Market conditions can be expected to have an impact on each of the Monitoring Categories. For example, in periods of elevated market volatility, each of the three Monitoring Categories could be expected to increase due to factors other than increased inflows or outflows in a Mutual Fund Class. For example, in response to increased market volatility, an index-tracking strategy may need to engage in more frequent portfolio trading in order to minimize tracking error, while an actively managed strategy may increase its cash reserves. Increased portfolio trading during times of market volatility may also increase realized capital gains. While these market impacts would not be attributable to the Combined Class Structure, and may not affect shareholders in each class of a Combined Class Fund differently, they could trigger an exceedance of a numerical threshold, if such threshold were based on a Fund's anticipated operations during normal market conditions.⁹

It may not be practicable to attempt to isolate fluctuations in each Monitoring Category that result solely from changes in market conditions from those that are a consequence, in whole or in part, of the Combined Class Structure. For example, the numerical threshold for cash levels may in practice be triggered as a result of a Combined Class Fund holding excess cash as a temporary defensive measure in times of market stress. While this would trigger a Board reporting requirement under the Relief, no Board action would be required where the Adviser can explain that the exceedance resulted from unusual market conditions. Choosing appropriate time periods over which to measure each numerical threshold may also help to avoid false positives in times of short-term market stress.

Counterbalancing Benefits

The Monitoring Categories represent areas of potentially heightened cost—primarily for ETF Class shareholders in a Combined Class Fund. Counterbalancing these costs to some extent will be cost savings as a result of economies of scale and the reduction of duplicative costs across multiple Funds. There also may be less quantifiable benefits, for example, with respect to basket construction or the reduction in trade-error risk when trading only for a single Fund rather than clones. We believe it would be reasonable for an Adviser and a Board to consider these benefits in setting the initial levels of the numerical thresholds. Alternatively, these benefits (some of which may not be easily quantified) could instead be taken into account in the Board's consideration of whether any remedial action is required in the event of an exceedance of a threshold. A Board might also consider the extent to which continued purchases of ETF Shares following disclosure of the potential heightened costs might be indicative of such counterbalancing benefits.

Calculating Costs Associated with Portfolio Transactions

In calculating the costs associated with portfolio transactions, an Adviser will need to consider a Fund's trading costs in a manner that accounts for

the different ways in which these costs are incurred. This will depend on the nature of a Fund's portfolio and the trading venues it utilizes. Trading costs come in a variety of forms, depending on the type of security purchased or sold. While securities purchased on an exchange are typically executed through brokers who charge a commission, commissions ordinarily are not charged on over-the-counter orders (including, for example, orders for debt securities), because a Fund typically pays a spread that is included in the cost of the security. An analysis of portfolio transaction costs should account for both the explicit costs (for example, brokerage expenses for equity trades) and the implicit costs (for example, spreads on fixed income trades) of portfolio transactions. Advisers that utilize third-party vendors to perform a trade cost analysis in connection with best execution monitoring and/or as part of their investment process (typically, in connection with equity trades) might consider whether these estimates would be helpful in monitoring for potential cross-subsidization or would merely introduce unnecessary complexity.

In addition, many ETFs impose variable asset-based fees to cover transaction costs incurred by the ETF in investing cash delivered by an Authorized Participant (AP). The methodology used for calculating these variable fees may help to inform the analysis of portfolio transaction costs.¹⁰ Other metrics also may be informative. For example, an Adviser may look to bid-ask spreads in the ETF Share Class, as changes in such spreads may be indicative of changes in transaction costs associated with purchasing/selling the securities held in creation and redemption baskets, which could potentially serve as an indication of trading costs with respect to the Fund's portfolio.

Time Periods for Measurement

The Relief requires that the Board approve both the numerical thresholds and the time periods over which those thresholds are measured. These time periods are likely to be different for different

thresholds and may be either static or rolling. For example, while it may be reasonable to measure portfolio transaction costs on a quarterly or even monthly basis (or over a rolling period), those time periods may not be appropriate for the measurement of capital gains. The Adviser's tax management strategies typically will be targeted at managing net capital gains over the course of a Fund's taxable year, and peaks or troughs in realized gains over shorter periods may give an unreliable signal of the Adviser's success in managing the Fund's ultimate capital gain distributions.

The Cadence of Board Reporting and Remedial Actions

Reporting Exceedances

The numerical thresholds will have an impact on the frequency of Board reporting under an Adviser's Ongoing Monitoring Process. Exceeding a numerical threshold will trigger a requirement that the Adviser report such event to the Board no later than 30 days following the end of the applicable time period in which the threshold was exceeded.

Fund Boards typically meet at least quarterly. Thus, where the time period over which the numerical thresholds are measured is quarterly (or longer) this reporting requirement could be satisfied by providing a written report at each regular quarterly Board meeting, rather than implementing a separate procedure for Board reporting between meetings. However, in times of significant exceedances in the numerical thresholds, Advisers may determine that it is appropriate to report on those events more promptly than the minimum standard required under the Relief (that is, between Board meetings). Likewise, where a time period over which a certain threshold is measured is shorter than a fiscal or calendar quarter (for example, monthly), inter-meeting reporting to the Board may be required. In addition, we expect that in the period following the initial implementation of a Combined Class Structure, Boards might expect more frequent reporting from

the Adviser. Even in the absence of any exceedance report, Boards will be required to evaluate and approve the Combined Class Structure no less frequently than annually.

Potential Remedial Actions

If a Board receives a report of an exceedance, the Board will be required to decide, no later than its next regularly scheduled meeting, what, if any, remedial actions the Adviser or the Combined Class Fund should take. The Relief recites the following as examples of potential remedial actions:¹¹

1. Adjustments to the use of in-kind transactions or trade execution strategy to manage costs associated with portfolio transactions;
2. Greater use of credit lines or other sources of cash to reduce uninvested cash;
3. Enhancements to tax lot management and harvesting of capital losses to reduce capital gains distributions;
4. Adjustments to transaction fees, purchase fees and/or redemption fees; and/or
5. Discontinuation of a class, or conversion of an entire class of a Combined Class Fund into another class of that Combined Class Fund as otherwise permitted under the 1940 Act.¹²

It is noteworthy that the Relief does not specify any circumstances in which a Board or an Adviser would be required to take remedial action. Instead, the decision about what action to take, if any, and under what circumstances, would be based on the business judgment of the Board.¹³

Prior to launching new classes in reliance on the Relief, Advisers should consider the feasibility of the various remedial measures highlighted above in light of the specific structure and characteristics of the Funds relying on the Relief. It will be important for Advisers to think through in advance other potential operational challenges associated with taking these remedial steps, the expected timeframe required to implement them, and their expected efficacy. This will likely involve conversations with the Fund's

service providers and the financial intermediaries through which Fund shares are sold (as well as some level of coordination across the industry as a whole). For example, one measure a Fund might utilize to address any material cross-subsidization concerns would be the imposition of purchase premiums and/or redemption fees on cash transactions for Mutual Fund Classes. The Adviser and the Board might also assess, in connection with proposing the Combined Class Structure, the operational feasibility of imposing such fees and the ability or willingness of brokers and other intermediaries to process such fees.¹⁴

Beyond Ex-Post Reporting

In some instances, pre-emptive action may be more appropriate than ex-post reporting. For example, in the case of a large purchase or redemption transaction in a Mutual Fund Class, the most appropriate remedial action might be to process the transaction in kind rather than in cash. But ex-post review of such a transaction, required if effecting the transaction in cash results in an exceedance of a numerical threshold (for example, portfolio transaction costs or capital gains), would be ineffectual, since the costs will have already been incurred.

An Adviser sometimes will have advance notice of a large shareholder purchase or redemption transaction in a Mutual Fund Class (for example, in the case of a planned portfolio rebalancing by a large institutional investor or required notice given by an investing fund in a fund-of-funds arrangement under Rule 12d1-4). We expect that an Adviser with advance notice of such a transaction might seek to manage the impact of the transaction if the Combined Class Fund would otherwise exceed a numerical threshold.

The Periodic Adviser Report

Content of the Report

In addition to the initial evaluation and approval of the Combined Class Structure, the Relief requires that a Board also evaluate the Combined Class

Structure at least annually and determine that it continues to be in the best interests of each Mutual Fund Class and the ETF Class individually and of the Combined Class Fund as a whole. To inform this evaluation and determination, an Adviser will be required to provide the Periodic Adviser Report. The elements of the Periodic Adviser Report are as follows.

1. A discussion of any observed benefits or cost savings to the Combined Class Fund resulting from the Combined Class Structure;
2. A discussion of any observed material conflicts of interest between ETF Class and the Mutual Fund Class(es), or observed material negative consequences to the ETF Class or the Mutual Fund Class(es) resulting from the Combined Class Structure, including the following:
 - a. Discussion of how creation and redemption activity in the ETF Class has affected the Mutual Fund Class(es) and how shareholder purchase and redemption activity in the Mutual Fund Class(es) has affected the ETF Class during the prior year, with respect to (i) cash levels; (ii) short- and long-term capital gains distributions; and (iii) costs associated with portfolio transactions;
 - b. Any performance difference between the Mutual Fund Class(es) and the ETF Class due to the difference in dividend payment dates; and
3. Any other information that the Board requests.

The Relief requires that a Board consider whether the Periodic Adviser Report suggests any issues relating to the Combined Class Structure, including conflicts between the classes, that require additional Board action. Based on this information, a majority of the directors of a Combined Class Fund, and a majority of the Independent Directors of the Board, are required to find, at least annually, that the multiple class plan continues to be in the best interests of each Mutual Fund Class and the ETF Class individually and of the Combined Class Fund as a whole.

Timing Considerations

Note that annual approval of a multi-class structure is not currently required under Rule 18f-3, so the approval required under the Relief will be novel. We expect that some Advisers may wish to make this reporting a new standard element of the annual 15(c) process, though we expect that the volume of new reporting required under the Relief and the volume of reporting in connection with the annual 15(c) process might counsel in favor of seeking this annual approval outside of that process. It might be sensible, for example, to consider this report in connection with the annual compliance review under Rule 38a-1 or the annual review of the Fund's liquidity risk management program under Rule 22e-4.

Disclosure Requirements

The Relief requires that a Combined Class Fund make certain public disclosures to ensure that investors clearly understand the nature of the Fund they are purchasing and the potential consequences of investing in a Combined Class Fund. Many of these requirements are targeted at avoiding investor confusion about the kind of shares they are buying. For example, a Combined Class Fund will need to use a generic term such as "ETF" in all references to its ETF Shares; it will need to offer ETF Shares and Mutual Fund Shares in separate prospectuses; it will need to make clear that ETF Shares are traded on an exchange and not individually redeemable; it will not market ETF Shares as a Mutual Fund investment; and it will need to include educational material on its website, explaining the differences between ETF Shares and Mutual Fund Shares.

In addition, a Combined Class Fund will need to disclose the key characteristics and risks associated with the Combined Class Structure, including any conflicts of interest arising from the fact that transactions through one class could generate portfolio transaction costs and tax consequences for shareholders of other classes. Disclosure should also explain the differences in dividend practices

between the Classes, including any applicable black-out periods that may apply, and the mechanics of the Exchange Privilege, if any.

Potentially Novel Issues for Some Mutual Fund Sponsors

Some Mutual Fund sponsors who do not currently offer ETFs may seek to rely on the Relief to launch an ETF Class. These sponsors will need to become familiar with the various legal and operational nuances of operating a registered fund whose securities trade on a securities exchange. These include, among other things:

- Establishing relationships (and, as appropriate, contractual arrangements) with APs, market-makers and other liquidity providers, listing exchanges and DTC.
- Developing a portfolio implementation and capital markets function for addressing in-kind purchases and redemptions and creating and accepting “baskets” for create/redeem transactions and facilitating relationships with APs, market-makers and exchanges.
- Preparing systems, operations, and business teams for the portfolio transparency required by Rule 6c-11.
- Becoming familiar with applicable exchange listing rules.
- Creating new compliance policies and procedures to comply with Rule 6c-11, the conditions of the Relief and exchange listing requirements and modifying existing Fund and Adviser policies to contemplate ETFs.¹⁵
- Developing Board reporting on ETF trading issues, including reporting on premiums and discounts, bid-ask spreads and liquidity/trading volumes, including creation and redemption activity.
- Educating ETF Boards on unique Section 15(c) review issues, for example, the ways in which the evaluation of unitary management fee agreements may differ from the evaluation

of traditional advisory agreements, particularly with respect to peer comparisons.

- Educating internal teams regarding the ecosystem for and operation of ETFs, including the fact that ETFs can be capital markets instruments that can be pledged, loaned, borrowed, margined or sold short.

Conclusion

As the Fund industry gets closer to being able to offer Combined Class Funds, Advisers and Boards will need to invest time and resources in preparing the Initial Adviser Report and developing the numerical thresholds and the Ongoing Monitoring Process. While we anticipate that industry best practices will develop over time, at the outset there likely will be some trial and error and periodic recalibration may be necessary in order for Funds to fully realize the benefits of the Combined Class Structure.

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NOTES

- ¹ These categories, which are explicitly named in the Relief, are the same as those named in the SEC’s adopting release for Rule 6c-11 as giving rise to concerns related to cross-subsidization. See *Exchange-Traded Funds*, SEC Release Nos. 33-10695; IC-33646 (available at <https://www.sec.gov/files/rules/final/2019/33-10695.pdf>), pages 122-123. The Relief also permits an Adviser to recommend the establishment of additional numerical thresholds designed to identify other conflicts of interest between classes. For example, in addition to the three categories specifically named in the Relief, an Adviser might also consider implementing a numerical threshold with respect to settlement fails on creations and redemptions in the ETF Class.

Although ETFs typically collect collateral to ensure settlement of creation transactions, if an Authorized Participant (AP) were to fail to settle, and the collateral was insufficient to meet the Fund's cost to cover (or if the missing security cannot be obtained), that would affect the Fund as a whole.

- ² However, as in the case of the Board's initial approval of the Combined Class Structure, in considering appropriate numerical thresholds, we believe a Board might reasonably determine that the most appropriate benchmark is not the historical experience of a similarly managed stand-alone Mutual Fund or ETF (or a hypothetical stand-alone vehicle), since such a Fund may not, in practice, be a viable alternative given the scale at which a Combined Class Fund expects a new Mutual Fund Class or ETF Class to operate.
- ³ Alternatively, these benefits might be ignored for purposes of setting the numerical thresholds themselves, but considered in connection with a Board's decision about what remedial action, if any, is warranted in the event of an exceedance.
- ⁴ This data, may in turn, be based on historical data for the Fund, if available, but would be informed by a number of other factors.
- ⁵ An existing ETF might be expected historically to have experienced lower costs within some or all of the Monitoring Categories compared to an existing Mutual Fund, and thus, if only historical data for that ETF were considered, that would be reflected in the numerical thresholds.
- ⁶ As noted below, the Relief contemplates that the numerical thresholds will be evaluated periodically, and at least annually, and may be adjusted in connection with that evaluation. If a Fund were to base the thresholds narrowly only on historical data for the Fund in question, we expect that, as the Fund's new share classes reach scale, it would be appropriate for the numerical thresholds to be adjusted (either up or down) in light of evolving operational realities and expenses.
- ⁷ In addition, existing Funds that are not currently managed by the Adviser may provide relevant data. An Adviser may, for example, have launched a clone

or near-clone ETF of a Mutual Fund, but shuttered the ETF after it failed to gain scale. If the Adviser now seeks to add an ETF Class of the at-scale Mutual Fund, the experience of the now closed ETF might be appropriate for consideration.

- ⁸ Namely, use of in-kind purchases and redemptions can create a pool of securities in which the Fund's tax basis is essentially the current market price, and if there is a need to sell securities within the Fund, such lots could be sold without triggering the realization of significant capital gains.
- ⁹ During periods of market volatility (for example, March 2020), the market prices of fixed income ETFs have tended to decline more quickly than the prices of underlying fixed income securities. As a result, the market price of a fixed income ETF may trade at a potentially meaningful discount to the ETF's NAV while market participants seek to determine the price of the underlying fixed income securities. The ETF may sometimes function as a price discovery vehicle. See https://www.ici.org/doc-server/pdf%3A20_rpt_covid2.pdf; and <https://www.sec.gov/spotlight/fixed-income-advisory-committee/100520-sec-conference-bond-etf-behavior-during-covid-volatility.pdf>.
- ¹⁰ In monitoring for exceedances of the numerical threshold for portfolio transaction costs, an Adviser may also consider how to account for the variable fees charged with respect to cash baskets. For example, if the Fund receives a fee when it receives a cash basket, it may be sensible, for purposes of applying the numerical threshold, for that fee to offset the trading costs incurred in connection with putting the cash to work in the portfolio. In that case, the numerical threshold would only be exceeded to the extent there were trading costs that were not otherwise offset by such a variable fee.
- ¹¹ Notably absent from the list of remedial measures explicitly named in the Relief is the use of swing pricing, which is permitted under Rule 22c-1. While swing pricing could, in theory, provide a mechanism for efficiently allocating the costs of transactions in Mutual Fund Shares only to those classes, the industry has had ample opportunity to consider swing pricing

and has found implementing the mechanism to be unworkable. See https://www.ici.org/swing_pricing.

- ¹² A Board might also consider spinning out a share class into a new Fund, though note that it is not currently possible to spin out a share class on a tax-free basis. The Investment Company Institute has been engaged in efforts to obtain guidance from the Department of the Treasury and the IRS that would permit tax-free share class spinouts, and such efforts remain ongoing.
- ¹³ Note that the costs within each of the Monitoring Categories are not “expenses” of the Class under US Generally Accepted Accounting Principles and in some cases are not easily quantifiable. Trading costs are reflected in the price of the security bought or sold; cash drag impacts returns but is not an accounting expense, it will always be based on estimates, and it may have a positive impact on returns in down markets; realized capital gains can be quantified more precisely, but their cost to a shareholder will depend on the shareholder’s particular tax situation. This will have an impact on what remedial measures might be appropriate in the event of an exceedance. For example, because these costs are not “expenses,” an expense reimbursement agreement would likely be a blunt instrument for attempting to remedy a perceived cross-subsidization issue with respect to any of the Monitoring Categories.

- ¹⁴ We note that Vanguard funds relying on their existing relief disclose the possibility of imposing such fees, and certain mutual funds currently apply them. A Fund may want to determine, in the event it was to impose such a fee, whether it would implement a *de minimis* threshold.

- ¹⁵ Rule 6c-11 contains conditions regarding basket construction including custom baskets, website disclosure of bid-ask spreads and premiums/discounts, and portfolio holdings transparency. Under Rule 22e-4, ETFs have to consider two additional factors: (i) the relationship between liquidity and arbitrage and (ii) the effect of each basket on overall liquidity. ETFs that disclose their holdings daily and redeem their shares in kind (that is, using a *de minimis* amount of cash) generally are not required to classify assets or adopt a highly liquid investment minimum (though note a Combined Class Fund would be so required). Certain other ETF compliance policies and procedures may differ from many Mutual Fund policies and procedures: (i) monitoring of required posting of trading information (premiums/discounts, bid-ask spreads), (ii) often no frequent trading policy as ETF shares are purchased/sold in the secondary market, (iii) ETFs have no retail customers for data privacy and AML requirements (only APs), and (iv) ETFs must comply with exchange listing and 1934 Act rules.

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