

February 10, 2023

Applicant Files for Vanguard-Type ETF as a Share Class Exemptive Relief

On February 8, 2022, applicants filed an [application](#) (the “Application”) with the SEC for exemptive relief from various provisions of the 1940 Act and Rule 22c-1 thereunder to permit the applicants to create and operate an actively managed, exchange-traded share class of a traditional open-end registered investment company.

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- A likely catalyst for the application’s filing is the anticipated 2023 expiration of the ETF share class patent obtained by The Vanguard Group, Inc.¹
- Currently, Vanguard funds are the only open-end funds that have ETFs operating as an exchange-traded share class of a multi-class registered investment company. These Vanguard funds operate pursuant to SEC exemptive orders issued beginning in 2000 (the “Vanguard Orders”).²

The Application’s proposal requires exemptive relief because Rule 6c-11 under the 1940 Act does not provide relief from Sections 18(f)(1) or 18(i) of the 1940 Act, nor does Rule 6c-11 expand the scope of Rule 18f-3’s multi-class relief to permit an exchange-traded fund class of an open-end fund to operate.

- In the 2019 release adopting Rule 6c-11,³ the SEC expressed concern that an open-end fund with an exchange-traded share class that transacts in-kind with authorized participants and with another share class that transacts in cash with shareholders may give rise to differing costs to the fund. As a result, while certain of these costs may result from the features of one share class or another, absent a mechanism for allocating these costs solely to the appropriate class(es), all shareholders would generally bear these portfolio costs.
- Similarly, such an open-end fund, through its in-kind creation and redemption process, would provide tax benefits that would accrue to all shareholders, including open-end fund shareholders who acquire the non-exchange-traded share class by transacting directly with the open-end fund in cash.
- Recognizing these significant differences between traditional ETFs and open-end funds with an exchange-traded share class, the SEC excluded such open-end funds from the scope of Rule 6c-11.

Notably, the Vanguard Orders apply only to index funds. The Application requests exemptive relief that is broader than the Vanguard Orders by seeking exemptive relief to permit the applicants to operate an open-end fund with an actively managed, exchange-traded share class (an “ETF Class”). Significantly, the SEC declined to extend Vanguard’s Orders to actively managed ETFs in 2015.⁴

¹ See, e.g., Method for implementing an investment company that issues a class of conventional shares and a class of exchange-traded shares in the same fund, Pat. No. 6,879,964 (available [here](#)).

² See Vanguard Index Funds, Rel. Nos. IC-24680 (Oct. 6, 2000) (notice) and IC-24789 (Dec. 12, 2000) (order); Vanguard Index Funds, Rel. Nos. IC-26282 (Dec. 2, 2003) (notice) and IC-26317 (Dec. 29, 2003) (order); Vanguard International Equity Index Funds, Rel. Nos. IC-26246 (Nov. 3, 2003) (notice) and IC-26281 (Dec. 1, 2003) (order); Vanguard Bond Index Funds, Rel. Nos. IC-27750 (Mar. 9, 2007) (notice) and IC-27773 (Apr. 25, 2007) (order).

³ The Rule 6c-11 adopting release is discussed in a 2019 Ropes & Gray [Alert](#).

⁴ See E. Graffeo & S. Potter, *Vanguard’s One-of-a-Kind Fund Design Is About to Get Some Competition*, Bloomberg (Feb. 9, 2023) *citing* The Vanguard Group, Inc. File No. 812-14287 (Oct. 9, 2015) (application).

Observations. The Application is interesting because it should initiate useful dialog with the Division of Investment Management staff (the “Staff”) about the potential merits of the ETF-as-a-share-class structure and the appropriate allocation of costs and benefits across different classes. We expect the Application to be only the opening bell for what may be a fairly long and involved conversation with the Staff given that the Application addresses some of the issues raised by the SEC in the Rule 6c-11 release in a fairly summary manner and suggests that only a handful of conditions would be needed to govern this arrangement. In addition, we also understand significant engagement with the Staff – not to mention the Commission – will be required to obtain the requested relief and that success in that regard is by no means assured. However, given the tremendous benefits of the requested relief, industry participants may nonetheless wish to file their own form of application for relief to ensure that the Staff hears their views on these issues and to preserve a place in line should the SEC grant the relief in some fashion.