



K&L GATES

Mutual Fund to ETF Conversions

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AGENDA

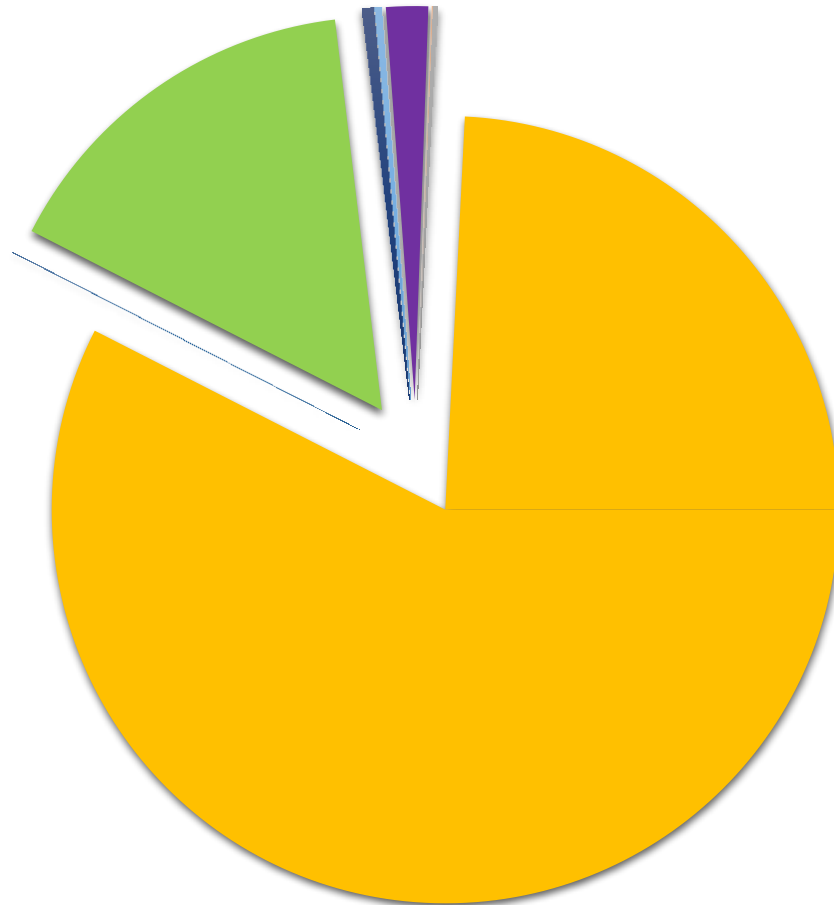
- Recent History
- Why ETF Conversions?
- Board of Trustees' Considerations
 - Legal
 - Operational
 - Tax
 - Accounting
- Conclusions

Recent History

MUTUAL FUND – ETF CONVERSION TIMELINE

Date	Firm	AUM
March 2021	Guinness Atkinson	\$30 million
June 2021 & Sept. 2021	Dimensional Fund Advisors	\$44.6 billion
Sept. 2021	Foothill Capital Management	\$5.1 million
Nov. 2021	Adaptive Investments	\$110.7 million
Dec. 2021	Motley Fool	\$942 million
April 2022 – June 2022	JP Morgan	\$8.5 billion
May 2022	Harbor Capital	\$148 million
Expected Third/Fourth Quarter 2022	Franklin Templeton	\$253 million

AN OVERVIEW



- Guinness Atkinson
- Adaptive Investments
- Dimensional Fund Advisors
- Foothill Capital Management
- JP Morgan
- Franklin Templeton
- Harbor Capital
- Motley Fool

Why ETF Conversions?

THE ETF RULE

Before the ETF Rule was adopted, ETFs relied on exemptive orders to operate as ETFs. Those orders required ETFs to transact **only** with Authorized Participants. There were **no exceptions** to this requirement.

Under the ETF Rule, ETFs are **excepted** from the requirement to transact **only** with Authorized Participants in connection with transactions, such as fund reorganizations and mergers. This subtle change laid the groundwork for conversions today.

THE ETF RULE

- Allow the “vast majority” of ETFs to operate without obtaining an SEC exemptive order

- Permitted to rely on the Rule:
 - All transparent ETFs
 - Index-based ETFs
 - Active ETFs

- Not permitted to rely on the Rule:
 - UIT ETFs
 - Non-transparent active ETFs
 - Multi-class ETFs
 - Non-RIC ETFs

REASONS FOR CONVERSIONS

- Lower cost
 - Advisory fee structure i.e. unitary vs. traditional
 - Distribution costs
 - 12b-1 and shareholder servicing fees
 - Lower service provider expenses
 - Investor interest in model portfolios
- Potentially significant tax benefits
- Use of active non-transparent models
- Preserve performance track record

Board of Trustees' Considerations

LEGAL CONSIDERATIONS

- Appropriateness of investment strategy for ETF
 - Transparency acceptable for strategy
 - Supports arbitrage mechanism
 - Portfolio liquidity and pricing transparency
 - Expected portfolio turnover/potential tax benefits
 - Changes needed to the principal investment strategies
 - Effect of the conversion on the Fund's total operating expenses
 - Adviser's ETF Capabilities

LEGAL CONSIDERATIONS (CONT'D)

- ETF Rule and Exchange Listing Compliance
 - Satisfy the definition of an Exchange Traded Fund under the Rule
 - Regulated investment company (“RIC”) under the Code
 - Transparency – post required information on the ETF website, including:
 - Complete portfolio holdings
 - Premiums and discounts
 - Bid-ask spreads
 - 50 Shareholders after 12 months
- Service provider agreements
 - New and additional services
- Compliance Policies and Procedures
 - Modify to accommodate ETF structure
- Costs of the conversion and who will bear them

LEGAL CONSIDERATIONS (CONT'D)

- How is the conversion accomplished –
 - Direct conversion (of all series in a trust)
 - Shell reorganization
- Board Approval of Reorganization – Rule 17a-8
 - Majority of same independent directors as majority of target board
 - Same advisory fee/arrangement
 - Board findings: best interest of target and shell funds; non-dilution of target (unique in the ETF context)
 - Potential conflicts of interest for affiliated funds invested in the target funds and voting on the reorganization

OPERATIONAL CONSIDERATIONS

- Share Classes and 12b-1 Plans
 - ETFs under the ETF Rule have one share class and cannot charge a sales load
 - Combine multiple mutual fund share classes into one class for the reorganization or conversion
 - ETFs typically employ only a defensive 12b-1 Plan
 - Align converting mutual fund share class
- Shareholder Accounts
 - Mutual fund shareholders may hold at transfer agent
 - ETF shares will need to be held in brokerage accounts
- Fractional shares

OPERATIONAL CONSIDERATIONS (CONT'D)

- Expense Structure Differences
 - Most mutual funds employ a traditional advisory fee
 - Most ETFs employ a “unitary” fee
- Portfolio Management
 - Most mutual funds sell and redeem their shares strictly for cash, and the investment team trades into and out of positions
 - Most ETFs transact in-kind with baskets
- Authorized Participant and Lead Market Maker Relationship

TAX CONSIDERATIONS

■ Direct Conversions

- Same entity; amend SEC registration statement and organizational documents; change operations
- Generally no direct tax consequences to fund or shareholders
- Shareholders have mutual fund shares exchanged for ETF shares of same RIC
- if receiving cash for fractional shares, taxable gain/loss on cash component
- Carryover tax basis and holding period in assets

■ Reorganizations

- Transfer assets of mutual fund into newly created ETF shell
- Qualifies as a tax-free “F reorganization” (Section 368(a)(1)(F))
- Tax entity continues without interruption (EIN, taxable year, Section 381-382 tax attributes etc.)
- Generally no direct tax consequences to fund or shareholders, but if shareholders receive cash for fractional shares, taxable gain/loss on cash component
- Carryover tax basis and holding period in assets

TAX CONSIDERATIONS – “SHELL” OR “F” REORGANIZATIONS

- Six conditions must be satisfied for a shell reorganization to qualify for tax-free treatment
 - 1) The resulting ETF shares must be distributed in exchange for the target mutual fund shares
 - 2) There is an identity of ownership in the ETF and mutual fund before and after the reorganization
 - 3) The acquiring ETF has no prior attributes or assets
 - 4) The transaction will result in the liquidation of the mutual fund
 - 5) The resulting ETF is the only acquirer in the transaction
 - 6) The target mutual fund is the only target in the transaction

ACCOUNTING AND PERFORMANCE CONSIDERATIONS

- Target mutual funds should be accounting survivor
- Performance
 - Portability of Performance – Prior Performance
 - SEC Staff Position: Mass Mutual, No-Action Letter (1995)
 - FINRA Position
 - Compare to “Related” Performance

CONCLUSION

- The market has signaled a preference for the ETF structure.
- The ETF Rule has laid the regulatory foundation for conversions of mutual funds into RIC ETFs, provided primarily that the fund manager is comfortable with portfolio transparency.
- Beyond the legal considerations, however, are operational and business considerations, such as –
 - Moving shareholders into brokerage accounts
 - Combining share classes and
 - Rationalizing 12b-1 Plans.
- Tax considerations will inform significantly how to effect a conversion.
- Today, our discussion has focused on mutual fund conversions. Other types of conversions are possible, including SMA conversions, and private and closed-end fund conversions.

Questions

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