BOARD OVERSIGHT: ETFS AND MUTUAL FUNDS

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When a complex offers both mutual funds and ETFs, it can pose unique challenges to board oversight.

Board Oversight: ETFs and Mutual Funds

TOPICS COVERED

BOARD DUTIES THAT OVERLAP AND THOSE THAT DIFFER

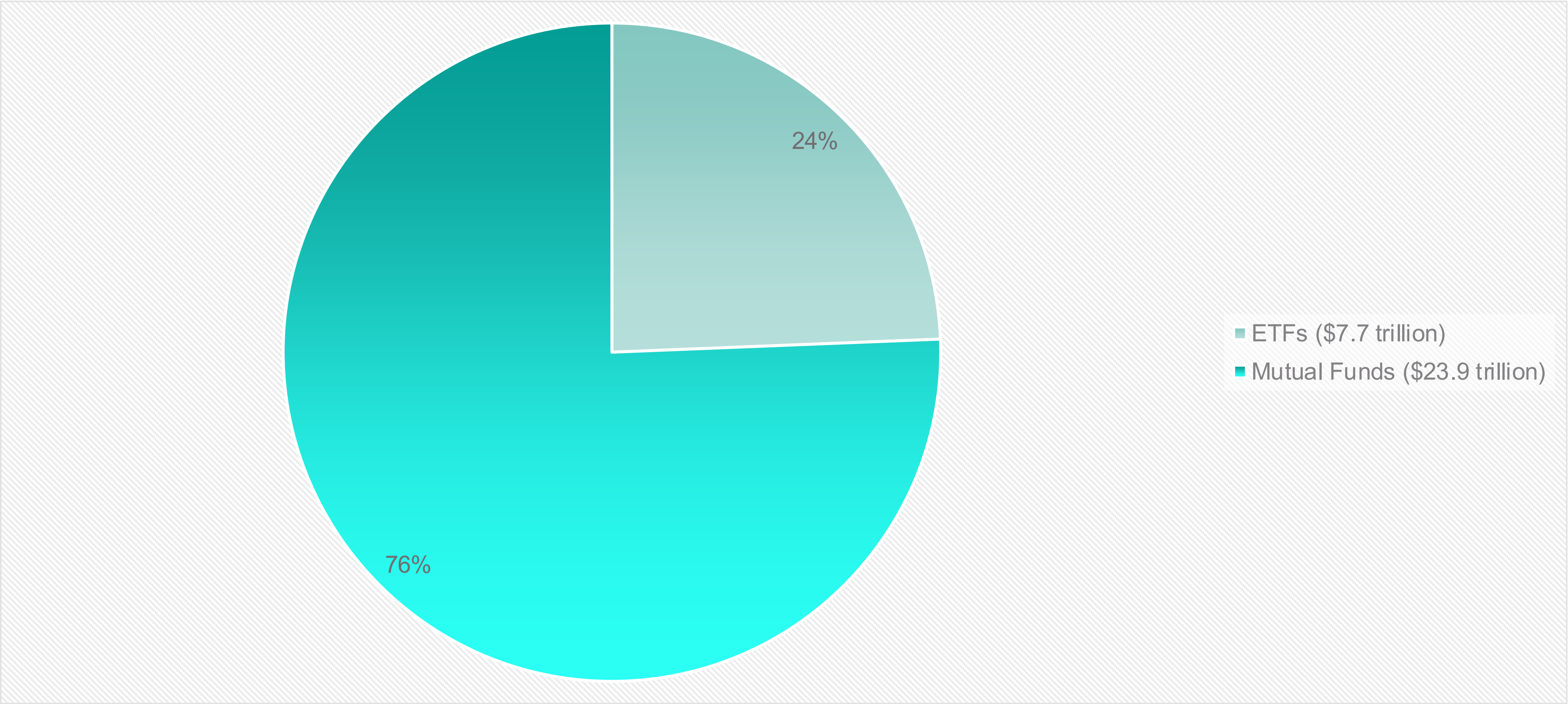
DIFFERENT AREAS OF COMPETENCY IMPORTANT TO THE OVERSIGHT OF MUTUAL FUNDS AND ETFS

POTENTIAL CONFLICTS OF INTEREST AND COMPLEXITIES RELATING TO THE 15(C) PROCESS

- DEALING WITH CHALLENGES POSED BY ETFS THAT ARE CLONES OF EXISTING FUNDS
- ISSUES PRESENTED ON CONVERSION OF EXISTING MUTUAL FUNDS INTO ETFS

TRUSTEE COMPENSATION, BOARD MEETINGS AND OTHER PRACTICAL CONSIDERATIONS

ETFs and Mutual Funds Market Share



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Board duties

- A board's fiduciary duties under state law and statutory obligations under the 1940 Act are the same for mutual funds and ETFS
- In practice however, the statutory obligations may differ.
- ETFs must also comply with:
  - Rule 6c-11, which imposes certain duties on boards
  - Exemptive orders, where applicable
- Both mutual fund and ETF boards must oversee advisers and other service providers, but there are differences in services and service providers and the services they provide differ.
- Some items do not apply to both products, for example:
  - ETFs typically cannot offer multiple share classes
  - AML becomes largely inapplicable to ETFs where there are no retail transactions
- Some items are the same or largely similar, for example:
  - Valuation
  - Fidelity bonding
  - Compliance oversight and CCO

Board Duties—How they may differ

ETFS

Distribution

- An ETF board is required to approve the distribution agreement between the ETF and its distributor.
- However, the role of the ETF distributor is to serve as intermediary between the ETF's transfer agent and the Authorized Participants (APs) in connection with the creation and redemption of ETF shares. The distributor is referred to as a "medallion distributor" (a term relating to its role with the transfer agent) and does not interface with retail investors or the brokers through which retail investors transact in ETF shares.
- Even where an affiliated mutual fund utilizes an affiliated distributor, the ETFs may be distributed through a medallion distributor.
- ETF distributor should oversee the Authorized Participants.

MUTUAL FUNDS

Distribution

- A mutual fund board is required to approve the distribution agreement between the ETF and its distributor.
- However, the mutual fund distributor may deal directly with the fund's retail investors and will deal directly with the financial intermediaries through which the retail investors purchase and redeem mutual fund shares.

Board Duties—How they may differ

ETFS

Distribution

- ETFs are permitted to pay 12b-1 fees, but typically do not. The board may be asked nonetheless to approve a Rule 12b-1 Plan.
- ETFs may enter into revenue sharing agreements, but these are governed by SEC exemptive relief under the Securities Exchange Act and do not raise the same issues as those relating to “distribution in guise.”

MUTUAL FUNDS

Distribution

- A mutual fund board may be asked to approve a Rule 12b-1 Plan and most mutual funds continue to charge 12b-1 fees.
- Oversight of distribution involves oversight of payments to distributors (12b-1 fees) and “sub-accounting” or “sub-transfer agency” fee payments to financial intermediaries, especially in connection with “distribution-in-guise.”

Board Duties—How they may differ

ETFS

Trading of ETF Shares

- ETFs trade on an exchange. The ETF board should receive reporting on whether the ETF's shares are trading at a price close to NAV or are trading at a discount or premium. If the ETFs are not trading at a price close to NAV, the ETF board should seek additional information as to the causes and consider if any remedial steps are required.
- The board may also receive reporting on topics such as bid-ask spreads, trading volume, and creation and redemption activity.
- The board of a semi-transparent ETF is also required to consider whether corrective action is required upon the occurrence of certain trigger events relating to trading.
- ETF boards must also be concerned with the listing requirements of the relevant exchange.

MUTUAL FUNDS

Trading

- Because mutual funds do not trade on exchanges and are always purchased and redeemed at NAV (plus applicable fees), the board does not have similar duties.

Board Duties—How they may differ

ETFS

Rule 6c-11

- Rule 6c-11 requires an ETF to adopt and implement policies and procedures governing the construction of creation and redemption baskets and the process that will be used for the acceptance of baskets. For custom baskets, the ETF must adopt additional policies and procedures.
- The ETF board must approve these policies as part of its obligations under Rule 38a-1.
- Rule 6c-11 also requires detailed website disclosure relating to holdings and other matters.
- Any failure to comply with Rule 6c-11 should generally be included in reporting from the CCO.

MUTUAL FUNDS

There are no comparable rules applicable to mutual funds.

Board Duties—How they may differ

ETFS

Exemptive Relief: Non-Transparent and Semi-Transparent Active ETFs

- Exemptive relief typically imposes very specific duties on the board to oversee premiums or discounts and/or wide bid-ask spreads.
- Specifically, for at least three years after an ETF's launch, if the difference between the closing price or bid/ask spread and the ETF NAV exceeds certain thresholds (1% under the Precidian order and 2% for proxy basket orders) or the tracking error between the proxy basket and the ETF NAV exceeds 1%, the board must meet to consider the continuing viability of the ETF, whether shareholders are being harmed and what if any corrective action is appropriate. Corrective actions could include changing lead market makers or listed exchange, various modifications in creation units or investment strategies or liquidating the fund.

MUTUAL FUNDS

There are no comparable provisions applicable to mutual funds.

Board Duties—How they may differ

ETFS

Taxes

- ETFs are generally tax-advantaged and utilize various tax strategies to minimize capital gains. Board should understand these strategies and receive reporting on any issues.

MUTUAL FUNDS

Taxes

- Mutual fund investors generally must pay taxes on capital gains distributions. Mutual funds have fewer available tax strategies to minimize these taxes.

Different Competencies for Directors

ETFS

- **ETF directors may benefit from experience with trading and capital markets.**

  ETFs trade on securities exchanges at the then-current market price. Authorized Participants also purchase or redeem ETFs in large blocks known as Creation Units. Retail investors purchase ETFs through their brokers just as they purchase other securities.

MUTUAL FUNDS

- **Mutual Fund directors may benefit from an understanding of mutual fund distribution.**

  The mutual fund distribution eco-system is specialized and involves an opaque system of payments. Particularly with regulatory attention to distribution-in-guise, mutual fund directors should understand how distribution payments flow from the funds to financial intermediaries and the distinction between payments made for servicing and those made for distribution.

Different Competencies for Directors

ETFS

- **ETF directors should understand the arbitrage mechanism that is intended to ensure that ETF market prices remain at or close to NAV.**

  An important feature of ETFs is the arbitrage that exists because the Authorized Participants continually purchase and redeem Creation Units of the ETF at NAV per share while investors may buy and sell shares on an exchange at market prices. Arbitrage is intended to ensure that ETF market prices remain at or close to NAV. Nonetheless, a discount or premium may exist between the NAV and market price and directors are tasked with oversight in this area.

MUTUAL FUNDS

- **Mutual fund directors may benefit from expertise in portfolio management or oversight of investment professionals.**

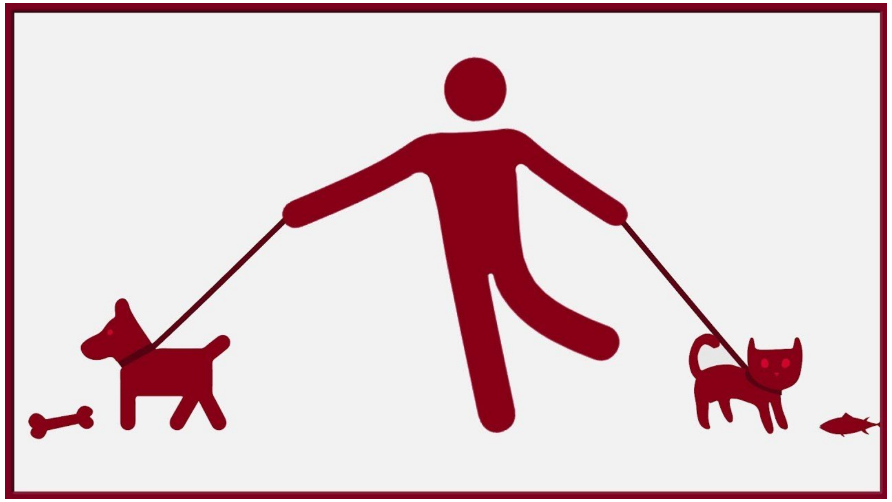
  For active strategies, mutual fund directors often spend considerable time analyzing performance. Expertise in portfolio management is useful in understanding how the portfolio is managed, risk, and return components.

Potential conflicts of interest

The operation of ETFs and mutual funds within the same fund complex presents several interesting potential conflicts, especially with respect to active ETFs that are clones of, or managed in a similar manner as, existing mutual funds in the same fund complex. Generally, a single board overseeing both products has better transparency into the operation of both and provides a single arbiter on resolution of conflicts, thus eliminating different standards and resolutions of conflicts that may be difficult to administer or explain to regulators or in a litigation context.

- Conflicts may include:
  - Cobranding, where one product has established the brand.
  - Portfolio management resources where similar or cloned strategies are involved.
  - Marketing resources and the risk of poaching.
  - Expense allocations and the risk of cross-subsidization, especially when new products are launching.

Potential conflicts of interest



Section 15(c)

One of the more interesting challenges faced by boards overseeing both ETFs and mutual funds is the reconciliation of fees, especially following the US Supreme Court's decision in *Jones v. Harris*, relating to the obligation for mutual fund boards to consider the fees charged by the funds' adviser for all comparable advisory services in the annual Section 15(c) process. In *Jones*, the Court made clear, "Even if the services provided and fees charged to an independent fund are relevant, courts should be mindful that **the Act does not necessarily ensure fee parity between mutual funds and institutional clients**…" and provided **significant deference to the board**, noting, "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process." This suggests that while there is room for difference in fees charged to mutual funds and ETFs overseen by a single board, the board must follow a robust process that creates an appropriate record validating the board's conclusion that the differences are justified.

Potential conflicts of interest

Conversion of existing mutual funds to ETFs

While still in its nascent stage, it is possible that the industry will increasingly see conversions of existing mutual funds into ETFs. Adoption of Rule 6c-11 and exemptive relief for non-transparent and semi-transparent active ETFs have potentially made this option more attractive to active equity managers.

- Two methods exist for conversion—direct conversion or a merger. Both options are somewhat complex and involve several steps. Direct conversions may require an exemptive order from the SEC.
- In either case, board approvals are required. In considering a conversion, the board may consider a variety of factors including:
  - Relative merits of the mutual fund structure and the ETF structure, including the tax benefits of ETFs.
  - Impact on shareholders, especially those who do not hold the mutual fund shares through a financial intermediary.
  - Comparative expenses both with respect to the management fees and various embedded costs, including trading costs associated with ETFs as a result of bid-ask spreads, which are borne by ETF shareholders. Note that in the Guinness-Atkinson conversion, fees were dropped materially upon conversion.
  - Costs of the conversion itself and how those will be allocated.
  - In the case of a merger, compliance with Rule 17a-8, if applicable.
  - Impacts on existing service provider agreements and relationships.
  - Experience of adviser in managing ETFs.

Practical Considerations

For a board overseeing both ETFs and mutual funds, there are several purely practical considerations.

- **Board compensation**. Are there measurable differences in time and liability that should be considered in setting board compensation and allocating the expense among the ETFs and the mutual funds. To date, ETF board compensation has been lower than that for mutual funds, which may be driven by various factors including AUM, perceived risk and complexity and the lower cost model for ETFs. In addition, there is relatively little data comparing ETF board compensation with mutual fund board compensation, leaving boards to exercise their best judgement as to appropriate compensation.
- **Meetings**. As boards struggle with increasingly lengthy meetings and ever-expanding agendas, organizing meetings productively to cover those matters in common and those matters relating only to the ETFs and mutual funds can be a challenge.
- **Audit Committee**. Boards should be mindful that the Audit Committee for an ETF must generally comply with the listing requirements of the exchange on which the ETFs trade and Rule 10A-3 under the Exchange Act. While the differences are not material, counsel should review the charters and policies to ensure compliance.
- **Board Education**. As a best practice, boards should engage in a regular program of board education. In the case of mutual fund boards that have recently undertaken the oversight of newly launched ETFs, additional education to understand the unique operational aspects of ETFs may be in order.