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# Preparing for ETFs as a Share Class



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# Preparing for ETFs as a Share Class

## Introduction

On March 17, 2025, Ropes & Gray published a white paper describing the much-anticipated Share Class Relief<sup>1</sup> 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. Two weeks after the publication of our white paper, the form of the Share Class Relief came into sharper focus. On April 1, 2025, Dimensional Fund Advisors LP and its affiliated Funds (“DFA”) filed with the Securities and Exchange Commission (“SEC”) an amended exemptive application that appeared to reflect significant input from the SEC staff.<sup>2</sup> Shortly after this filing, the SEC staff informed other applicants for the Relief that amending their applications to track DFA’s amended 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 responding to further SEC staff comments,<sup>3</sup> the basic framework remains substantially similar. The industry continues to expect that any final exemptive relief will follow the DFA model, which, in both form and content, mirrors our white paper to a significant extent. This updated white paper therefore tracks to some degree our March 17 white paper, making adjustments to conform to the specific conditions set forth in the Relief, as reflected in the DFA Application. Where this white paper 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 white paper, a moving target.

The new material in this white paper focuses primarily on the requirements for initial and periodic Board reports, as well as considerations relevant to the ongoing monitoring process, including the determination of the “numerical thresholds” contemplated by the Relief.<sup>4</sup> We anticipate that establishing appropriate numerical thresholds will be one of the more challenging aspects of implementing the Relief from a legal and regulatory perspective (a multitude of operational issues present their own significant challenges, as many readers of this white paper will be well aware). The discussion in Section IV below addresses some of the thornier interpretive and analytical issues associated with this feature of the Relief, as well as the initial and ongoing reporting and monitoring requirements under the Relief.

Like its predecessor, this white paper is intended to guide and inform Funds, their Advisers and their Boards as they prepare to take advantage of the Share Class Relief. While the discussion below is intended to serve as a useful reference point, we expect that there will be regular developments impacting Share Class Relief. We encourage sponsors considering the new share class structure to engage with their usual Ropes & Gray contacts early in the process. Alternatively, contact us at [ETFIInnovations@ropesgray.com](mailto:ETFIInnovations@ropesgray.com).

# The Share Class Relief

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 (the “Exchange Privilege”);<sup>5</sup> and
3. Be available to both actively managed and index-tracking Funds.<sup>6</sup>

The Share Class Relief is subject to a number of conditions, which generally are targeted at ensuring that a Combined Class Structure is in the best interests of each class individually and the Fund as a whole. In its adopting release for Rule 6c-11 under the 1940 Act,<sup>7</sup> 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>8</sup> That is, since Mutual Fund Class shareholders will typically transact in cash, while ETF Class shareholders will 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>9</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>10</sup> In particular, the Relief requires that an Adviser:<sup>11</sup>

1. prepare an initial report to the Board in connection with its approval of a Combined Class Structure (the “Initial Adviser Report”);
2. implement an ongoing monitoring process relating to the structure (the “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 (the “Periodic Adviser Report”).

The remainder of this white paper addresses each of these elements of the Relief and summarizes the other significant conditions of the Relief.

# 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>1. Description of the sources of potential cost savings and other benefits of a Combined Class Structure</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><b>Economies of Scale:</b></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> </ul>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<p><b>1. Description of the sources of potential cost savings and other benefits of a Combined Class Structure (Continued)</b></p>	<ul style="list-style-type: none"> <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><b>Benefits of a single fund structure:</b></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 (e.g., opportunities to piggy-back on existing trading, administration, audit and custody arrangements and to utilize a shared board).</li> <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—e.g., 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 (e.g., 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><b>Operation of the ETF Class:</b></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>



Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<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> <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>
<p><b>3. Description of the impact of reasonably expected cash levels</b></p>	<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>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<p><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></p>	<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> <li>Also consider any potential negative tax impacts to holders of the ETF Class from the existence of the Mutual Fund Class (e.g., 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>5. Discussion of how the Adviser intends to manage the reasonably expected costs associated with the transition to a Combined Class Structure</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> </ul>



Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<p><b>5. Discussion of how the Adviser intends to manage the reasonably expected costs associated with the transition to a Combined Class Structure</b> (Continued)</p>	<ul style="list-style-type: none"> <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>
<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>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<p>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</p>	<p><b>Existing Transaction Fees:</b></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><b>Different Dividend Payment Dates:</b></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.             <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> </li> </ul> <p><b>Differences in Servicing Costs:</b></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> </ul> </li> </ul>

Element of the Initial Adviser Report	Potential Approach to Analysis and Implementation
<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> (Continued)</p>	<ul style="list-style-type: none"> <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> <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> <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.

# 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 (i) costs associated with portfolio transactions, (ii) cash levels and (iii) capital gains distributions.<sup>28</sup> 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 (i) what combination of historical and/or projected data to use; (ii) whether/how to account for the impact of market conditions; (iii) how to account for unique issues that may be encountered during a new class ramp-up period; and (iv) how to weigh the counterbalancing benefits of a Combined Class Structure.

## Determining the Numerical Thresholds

### A. THE BIGGER PICTURE: THE 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 also 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.<sup>29</sup> An Adviser could also reasonably consider the projected benefits of the Combined Class Structure in setting the numerical thresholds.<sup>30</sup> The discussion below highlights a few considerations that tend to counsel in favor of this approach.

### B. 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.<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup>

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).<sup>34</sup>

In short, although historical data for existing Funds will often 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.

### C. 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 (i) the

existing ETF, (ii) a similarly situated Mutual Fund operating at scale or (iii) 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 U.S. equity securities and today incurs, on average under normal market conditions, brokerage expenses equal to 0.02% 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 would initially be expected to incur brokerage expenses equal to 0.02% 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.<sup>35</sup>

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.



#### D. 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.<sup>36</sup>

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.

#### E. 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 may also 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.

#### F. 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 (e.g., brokerage expenses for equity trades) and the implicit costs (e.g., 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 AP. The methodology used for calculating these variable fees may help to inform the analysis of portfolio transaction costs.<sup>37</sup> Other metrics may also 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.

#### G. 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 will typically 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

### A. 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 (i.e., 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.

### B. 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:<sup>38</sup>

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.<sup>39</sup>

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.<sup>40</sup>

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.<sup>41</sup>

### C. 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 will sometimes 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

## A. 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.

## B. 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 blackout 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.<sup>42</sup>
- 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.

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 will likely 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.



# Endnotes

<sup>1</sup> To enhance readability, certain capitalized terms are defined in the endnotes to this white paper, rather than in-line in the text. As used in this white paper, the “Share Class Relief” or the “Relief” means exemptive 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 an “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”). “Adviser” means an investment adviser to a Fund. “Combined Class Structure” means the multi-class structure contemplated by the Relief; “Combined Class Fund” means a Fund operating with a Combined Class Structure; “Board” means the board of directors or trustees of a Fund.

<sup>2</sup> See Dimensional Fund Advisors LP, et al., SEC File No. 812-15484 (Apr. 1, 2025) (amended application) (the “DFA Application”).

<sup>3</sup> See Dimensional Fund Advisors LP, et al., SEC File No. 812-15484 (May 30, 2025) (amended application).

<sup>4</sup> See Section IV, below.

<sup>5</sup> The Relief provides that 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>6</sup> The Relief does not, however, extend to semi-transparent active ETFs.

<sup>7</sup> The Investment Company Act of 1940, as amended.

<sup>8</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>) (the “Rule 6c-11 Adopting Release”), at footnote 425: “These costs [resulting from a 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 white paper 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>9</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>10</sup> In preparation for launching a new class in reliance on the Relief, a Fund will also 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. See Section VI below, which summarizes the specific disclosure requirements under the Relief.

<sup>11</sup> The Relief makes clear that if a Fund has engaged an investment sub-adviser, the primary investment adviser will be responsible for ensuring compliance with the conditions of 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 intra-day 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. See Section IV below, which addresses 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, note 8 above at page 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>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, note 8 above at page 58.

<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.

<sup>28</sup> These categories, which are explicitly named in the Relief, are the same as those named in the Rule 6c-11 Adopting Release as giving rise to concerns related to cross-subsidization (See note 8 above). 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 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.

<sup>29</sup> 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.

<sup>30</sup> 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.

<sup>31</sup> 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.

<sup>32</sup> 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.

<sup>33</sup> 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.

<sup>34</sup> 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.

<sup>35</sup> 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.

<sup>36</sup> During periods of market volatility (e.g., 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](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>.

<sup>37</sup> 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.

<sup>38</sup> 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](https://www.ici.org/swing_pricing).



<sup>39</sup> 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 Treasury and the IRS that would permit tax-free share class spinouts, and such efforts remain ongoing.

<sup>40</sup> Note that the costs within each of the Monitoring Categories are not “expenses” of the Class under U.S. 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.

<sup>41</sup> 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.

<sup>42</sup> 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 (i.e., 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.



The Share Class Relief represents an exciting opportunity for Fund sponsors to expand and improve their existing offerings in a cost-effective manner. While implementation will no doubt involve certain challenges and complexities, given our broad fund industry contacts and unmatched ETF operational expertise, Ropes & Gray is well positioned to help Fund sponsors and Fund Boards navigate them. Please reach out to your regular Ropes & Gray contact or contact us at [ETFInnovations@ropesgray.com](mailto:ETFInnovations@ropesgray.com).

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