What is your ETF strategy?

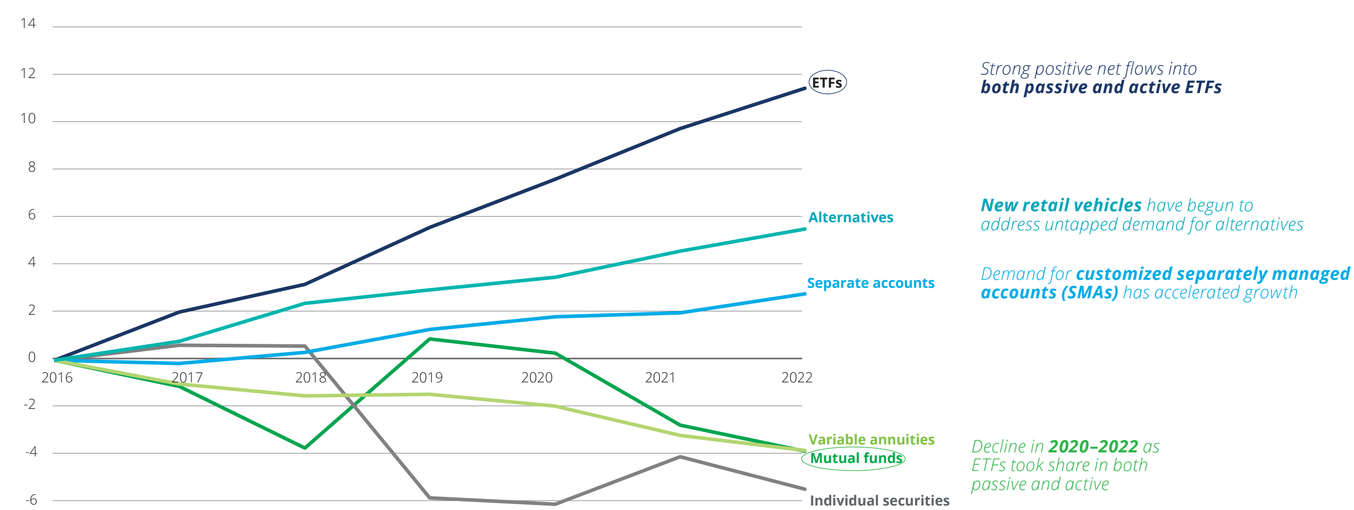
Three paths to success

The exchange-traded fund (ETF) market has seen significant growth over the past few years, fueled by the passing of rule 6c-11 by the Securities and Exchange Commission (SEC) in 2019, which significantly reduced the barriers to entry into the ETF market. ETFs have grown about 15% annually over the past 13 years, almost three times faster than traditional mutual funds.[1]

And while there are several product development trends underway for 2024, involving different views on packaging, pricing, investment strategy, themes, and operational approach to investment offerings, ETFs are often at the forefront of the conversation.

Figure 1. ETFs have rapidly taken market share, largely at the expense of mutual funds

US retail vehicle market share
Advisor-sold products; YoY change in market share, indexed to 0, 2016–2022



Note: Alternatives includes private funds, BDCs, interval funds.
Source: Casey Quirk Global Demand Model, Casey Quirk estimates and analysis.

ETFs were first launched in 1990, but they have taken significant share in recent years, largely by serving as the preferred vehicle for indexed strategies. Now ETFs are one of the main drivers of innovation in the investment management industry. The pricing, tax, and liquidity characteristics of ETFs have led to an expansion of their use, while placing competitive pressure across the industry.

Under rule 6c-11 of the Investment Company Act of 1940, ETFs that satisfy certain conditions can operate without the expense of obtaining SEC exemptive relief. Of course, ETFs that avail themselves of rule 6c-11 are still required to file a registration statement on Form N-1A with the SEC prior to a public offering. ETFs that are able to rely upon rule 6c-11 are (i) registered open-end management investment companies, (ii) that issue (and redeem) creation units to (and from) authorized participants in exchange for a basket and a cash balancing amount (if any), and (iii) that issue shares that are listed on a national securities exchange and trade at market-determined prices. Rule 6c-11 does not provide relief for other types of ETFs including, but not limited to, those organized as unit investment trusts, an ETF that is offered as a share class of an open-end fund with multiple classes of shares representing interests of the same portfolio, or an actively managed ETF that does not provide daily portfolio transparency.

Actively managed ETFs are growing in prevalence, as traditionally active managers grow comfortable with newer transparency rules and seek to open new distribution opportunities. While the concept of active management in an ETF is not new, 2023 saw rapid growth in the adoption of actively managed ETFs by investors. The assets under management (AUM) for actively managed ETFs rose 40% year over year in 2023.[2] Increased tax efficiency and enhanced transparency are likely driving this trend.[3] Actively managed ETFs continue to grow through fund launches and strong net flows. At year-end 2023, global active ETFs reached $740 billion in AUM, and they continue to grow in 2024.[4] A healthy slate of mutual-fund-to-ETF conversions contributed to the significant growth of actively managed ETFs in 2023, with 36 funds converting from mutual funds to ETFs during the year.[5] With the now-broad menu of actively managed ETFs available, a majority of financial advisers and retail investors indicated actively managed ETFs will likely become part of their future investment portfolios.[6]

Investment management firms will likely step up activities to meet this financial adviser and investor demand for actively managed portfolios within an ETF wrapper/vehicle. Even with significant headwinds of a market currently dominated by a handful of players—75% sponsored by the top three ETF sponsors, investment managers committed to expanding their product offerings are getting into the ETF marketplace.[7] As of December 31, 2023, 34 of the top 50 investment managers had entered the active ETF market—16 since 2021.[8] Thus, optimism is high, but market entry will require several key considerations.

Today, we explore three ways to make a strategic play in the ETF market. Each has regulatory, accounting, reporting, tax, and operational considerations that are unique and common to the path chosen. We expect that conversions from mutual funds will accelerate, firms will explore adding ETF share classes to existing mutual fund structures and, of course, old-fashioned new ETF launches. Before we explore each of these paths, let's look at the current three-year trend.

Figure 2

	2021	2022	2023	2024*
Old-fashioned ETF launches	371	347	512	31
Conversions of MFs to ETFs	1	33	36	TBD
ETF share class of MF (pending SEC approval)	0	0	4	6

Sources: Conversions – Bloomberg & Morningstar (from Casey Quirk, a Deloitte Business);
Launches – Refinitive; ETF- share classes- SEC Edgar Database Feb 2024.
*Data until Q1 2024.

Old-fashioned ETF launch

For firms with no existing ETF products there will be a number of regulatory, accounting, reporting, tax and operational issues to consider in executing your ETF strategy. If the choice is to launch a new ETF, one key difference between a mutual fund and ETF relates to disclosure of portfolio holdings on a daily basis. For firms with no existing ETFs, they will want to decide upfront whether to shield their ETF portfolio holdings through the semi-transparent active wrapper, which will require SEC exemptive relief.

The selection of third-party service providers will be a critical part of the launch decision and process, including the distributor, custodian, transfer agent, Authorized Participants (APs), and legal and audit firms. One key area that will take time to get right is the basket creation and redemption process done by the front office team, which is consistently highlighted by investment advisers as one of the most time-intensive processes in launching an ETF. Investment advisers will want to develop creation and redemption processes. This will involve developing relationships with APs and market makers, executing AP agreements, and establishing creation/redemption order guidelines. A fresh look at compliance processes will also be warranted as some changes to a fund's policies will need to be evaluated in launching an ETF, including ETF basket construction policies. If a firm does not have experience with ETFs, they may require significant operational and technology changes to support the new product. The establishment of a capital markets team—either in-house or outsourced—and the interaction with the APs is one of the main considerations in launching an ETF. Teams across the middle and back office supporting ETF operational processes, such as ETF settlements, NAV calculations, and reporting requirements, will require assessment and updates to their processes and procedures. Choosing the right advisor to help you navigate through program management, service provider selection, and operation model transformation, among others, is critical.

ETFs are typically seeded by a mixture of cash and securities. If the securities are contributed by APs, who are not shareholders in the ETF, there are likely no material tax considerations. If, however, securities are contributed by shareholders, or the ETF was the result of a conversion from an investment partnership or one or more SMAs, analyzing whether the seed transaction qualifies for tax-free treatment under Internal Revenue Code (IRC) section 351 is an important consideration. The contributing shareholders must collectively own at least 80% of the ETF immediately after the contribution (“control test”), and the securities contributed must be considered adequately diversified (“diversification test”). In order to meet the diversification test, the portfolio of securities cannot include any one security that represents 25% or more of the total value of the portfolio, or five securities that in total exceed 50% of the total value of the portfolio. Consideration should be given to any subsequent contributions from a shareholder after the initial seed to assess if the control test can be satisfied.

For transactions that do qualify for tax-free treatment, the ETF generally has a tax basis in the securities equal to the lower of fair market value or adjusted tax basis of each security in the hands of the contributed shareholder immediately prior to contribution. The contributing shareholders generally have tax basis in the ETF equal to adjusted basis in the property contributed.

Tax “efficiency” is often considered a key benefit of an ETF. Much of the tax efficiency from the ETF comes from the ability to utilize “in kind” redemptions to defer the recognition of gain by the ETF shareholder. For ETFs that register with the SEC under the Investment Company Act of 1940 and elect to be taxed as a regulated investment company (RIC), the ETF can avoid recognizing gains on appreciated securities that are distributed to the APs in exchange for redeeming shares of the ETF. Because the gains are not recognized for tax purposes at the ETF level, they are not distributed to the shareholders. As such, the shareholder can avoid recognizing the gain on those appreciated securities until they ultimately dispose of their interest in the ETF.

However, not all investments of an ETF are able to utilize the above provision. For example, regulated futures contracts (RFCs), which are marked to market under IRC section 1256, are not able to benefit from this. Similarly, it is unclear whether the closing of a short sale would qualify for non-recognition. It is important that the ETF sponsor consider whether the trading strategy of the ETF would qualify for the type of tax efficiency that the shareholder could be expecting.

It is also important that ETF sponsors create and follow policies and procedures around the create and redeem process. Absent such policies and procedures, the IRS could question the economic substance of the transactions. Working with legal counsel to maintain compliance in this area is recommended, given the possible impact of an adverse determination.

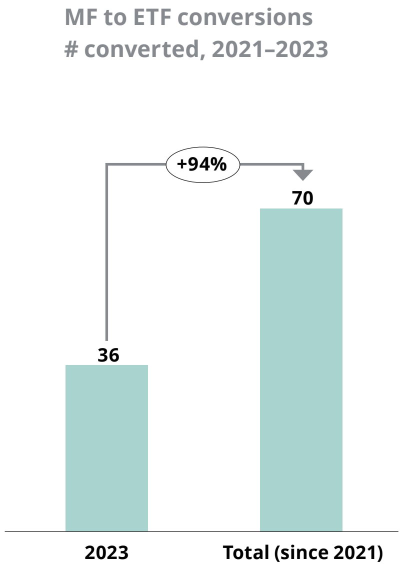
Given the provision through which ETFs benefit from non-recognition of in-kind redemptions is specific to RICs, it is important that the ETF maintain its RIC compliance related to diversification, passive income requirement, and distribution requirements. Monitoring the diversification requirement is particularly important in the first year of an ETF, given that a common remedy to a discrepancy is unavailable in the first quarter of the RIC’s existence. Maintaining RIC compliance can help the ETF mitigate unnecessary entity-level corporate income tax.

From a financial reporting perspective, key differences for an ETF are the disclosures of the principal US market(s) on which the ETF’s shares are traded and a table showing the number of days an ETF’s market price per share was at a premium and discount to an ETF’s net asset value per share for the most recently completed calendar year (subject to certain exceptions) in the Management Discussion of Fund Performance (MDFP) section, disclosure of the basket creation and redemption process for shareholders, and any differences in valuation policies unique to the ETFs (for example, the valuation policies around foreign securities and adjustment factors).

Convert a mutual fund to an ETF

Since March 2021, more than $60 billion in mutual funds have converted to ETFs.[9] The first firm to complete a conversion was Guinness Atkinson in 2021. Since then, JPMorgan, Franklin Templeton, Fidelity, and Dimensional have converted mutual funds, with others planned for 2024.[10] The conversion path has a number of advantages, including the ability to retain the fund’s performance track record and brand recognition, as well as less cash drift, lower operational costs and more tax efficiency than a mutual fund. There are, however, some potential challenges to consider, including the fact that mutual funds that are widely used in 401(k) plans may not be a good fit for an ETF conversion, due to plan recordkeeper limitations associated with intraday trading and fractional shares. Unlike mutual funds, ETFs do not usually issue fractional shares; therefore, managers will need to redeem those shares ahead of any conversion. Also, it’s not possible for shareholders to invest directly in an ETF because they are traded on the secondary market. ETF shares are always held in brokerage accounts. This is a logistical challenge when converting a mutual fund to an ETF as not all shareholders have brokerage accounts. A fund sponsor would need to ensure these converted shares are transferred to an investor’s brokerage account before trading begins.

Figure 3. Mutual fund to ETF conversions ramped up in 2023, but flows haven't followed



Source: Morningstar, Bloomberg.

ETF conversions also present some regulatory risk as they were highlighted as an examination priority by the SEC in 2023.[11] The SEC is focused on 1) the adequacy of the notice to shareholders (specifically on content and timing), 2) the governance process around the conversion and appropriate oversight of the ETF after conversion, and 3) whether 12b-1 fees are being appropriately handled during the conversion process.[12] ETFs rarely charge 12b-1 fees, and an area that would be subject to scrutiny is if any 12b-1 fees collected from certain mutual fund share classes are being used to promote them as converted ETFs. Eliminating 12b-1 fees before the conversion, versus day of, is something to consider.

We know it's important to have good relationships with third-party service providers as they can be key to a successful conversion. This includes lawyers, APs, transfer agents, custodians, and auditors, who are typically involved. From a financial reporting perspective, there will likely be changes to disclosures that result from converting to an ETF including disclosing both the market and NAV per share, changes to fee disclosures, and if there is a merger, the related disclosures on the reorganization. Also, there may also be pricing changes as a result of the conversion to an ETF, and added disclosure around expense arrangement changes will need to be considered. Share class consolidation may be required as an ETF, and, as a result, the financial highlights may need to be recast to represent a single share class.

Another factor to consider is if the conversion will be carried forward through a direct converison, or through a merger with a newly created shell ETF under the same trust, or a new trust with the same board. A direct converison would require shareholder approval, whereas a merger will not. There have been no direct conversions to date. A merger, or reorganization, would only require approval from the fund's board, along with the filing of Form N14.

Conversion of a traditional mutual fund into an ETF is less burdensome; assuming the shareholder base and the fund holdings remain consistent. The transaction will likely qualify as a tax-free reorganization under IRC section 368(a)(1)(F) ("F reorganization").

Conversions are appealing as they follow where the flows are going (e.g., actively managed ETFs had their largest flows in 2023),[13] and many see the appeal in converting their mutual fund to the ETF wrapper. Time will tell whether the more strategic path will be to convert mutual funds to ETFs, or if the more advantageous one is to launch an ETF or wait on SEC action to register an ETF share class of an existing mutual fund.

A new path unlocks: ETF share classes

With the recent broad ability to create ETF share classes since the patent expiry in May 2023, several investment managers including Australia's PGIA and US firms Dimensional, Morgan Stanley, and Fidelity, have applied to the SEC to establish similar ETF share class structures for their existing passively managed mutual funds. Additionally, it should be noted that to date, the SEC has not approved ETF share classes for actively managed ETFs and has not indicated a willingness to approve applications for ETF share classes on actively managed mutual funds in the future. Thus, the success of this path depends on positive regulatory action. However, the benefits of ETFs as a share class of a mutual fund might make the wait worthwhile and lucrative. These potential benefits include the following:

1. ETF share classes are exempt from the daily portfolio holdings disclosures required by ETFs, which fall under Rule 6c-11.[14]
2. Tax "efficiency" for both the ETF and mutual fund share classes through the use of custom baskets for in-kind redemptions (CIKRs), reducing the distributions of capital gains tax to investors. An ETF share class extends the tax benefits of CIKRs to the mutual fund share classes unlike standalone mutual fund products. On the other hand, cash redemptions through the mutual fund can provide tax losses that can be used to offset capital gains liabilities generated in other share classes.
3. The ETF share class will have the existing performance and investment strategy of the mutual fund (similar to a mutual fund to ETF conversion), allowing for a more timely and less costly ETF launch. Additionally, this benefits investors and investment firms as ETFs continue to see growing inflows.
4. Investors who generally are interested in moving from their mutual fund into an ETF can convert their mutual fund shares into ETF shares of the same fund, without realizing capital gains.

If the firm has experience with launching/managing ETFs, then launching an ETF as a share class will most likely have less risk than a stand-alone ETF launch. This is because the ETF share class will likely benefit from the established fund's performance, investment strategy, and any operational programs already in place, such as securities lending.

While the SEC widened the ability to use CIKRs in 2019, the expiration of the patent on ETF share classes allows the benefits of these transactions to be applied to mutual funds through an ETF share class. CIKRs are a critical piece of realizing the tax benefits of the ETF as a share class for a mutual fund. As is the case for those launching ETFs for the first time, firms already utilizing CIKRs for their ETFs will require review of their process as mutual fund managers and supporting teams adjust for the capital markets ecosystem and ETF life-cycle. Additionally, these transactions are highly manual for operational teams and involve large movements of securities and cash (often in the billions for large firms), which require appropriate controls and oversight. The inclusion of mutual fund holdings in these already large and manual transactions requires increased risk and oversight across the ETF operational process.

The operating model and investment strategy for an ETF share class closely mirrors that of other ETFs, with slight differences in the approach to index rebalancing and corporate actions. The ability to utilize CIKRs limits capital gains distributions for investors, but may require adjustments to investment management systems to allow the input of the CIKR transactions across both the ETF and mutual fund book of records.

Although the ETF share class may create a beneficial tax environment, it is possible for tax liabilities to be passed to ETF investors if the mutual fund realizes significant capital gains, and conditions could affect the ability of the ETF share class to remove the capital gains. A process will need to be established to allow the mutual fund investors to convert their mutual fund shares into the ETF share class of the fund. While investors can convert from the mutual fund share class to the ETF share class, it should be noted they are unable to convert from ETF shares to the mutual fund share class. For firms experienced with ETFs and those looking to launch their first ETF, an ETF share class provides a potential opportunity to expand the product offering for investors while benefitting both ETF and mutual fund share class investors through decreased costs and taxes.

Governance considerations for all paths

- Is a conversion in the best interest of the shareholders (considering both costs of conversions as well as potential future returns)?
- Is there a plan, and are controls in place for onboarding new products?
- Does the investment manager have oversight capabilities and a current process for conversion or merger?
- Is the retention of and/or selection of a third-party service provider involved?
- Have 38a-1 and 206(4)-7 policies been updated for ETFs?
- Are employees being appropriately upskilled to ensure that they understand new operational processes, and are frontline personnel adequately positioned to speak with current or new shareholders?
- Can the current third-party service providers support the launch, conversion, or new class and its operational and financial reporting differences?
- Have all disclosures as a result of the conversion been updated for an ETF versus a mutual fund?

Is choosing a path a must?

As noted, over the past 12 years, ETF growth has outpaced that of mutual funds and nearly every other investment vehicle out there.[15] Despite low AUM share, ETFs are becoming the default vehicle for many new and active liquid products in the United States. Some of the top ETF providers are still experiencing solid growth rates, and new (and much smaller) entrants are having some success as ETFs continue to draw new investors.

We have covered three paths that investment managers can pursue to enter the ETF market. There are similarities and differences between all three methods, and the key to success will depend on executing on the strategy and meeting investor demand. To date, there have been successes and slow starts across each of these paths. Larger US mutual fund complexes have achieved success in the actively managed ETF market through repackaging, while others have focused on thematic or SCE (Sustainability, Climate, and Equity) strategies. However, putting the same wine in a new bottle is not always a winning formula. To achieve success on any path:

- An investment manager should start with a seasoned ETF leader. It's imperative to work with one that has experience and relationships with the market and key shareholders, especially with APs.
- The asset manager also needs to be committed to a well-thought-out marketing and distribution plan, given this will essentially be an extension of their existing business and product line; bolting it on as additive to the existing operating model is not a recipe for long-term success. Thus, focused investments of dollars, resources, education, and digital tools to enhance the operating model and talent pool can help drive an increased likelihood of success.

Lastly, an efficient and effective operating model with digital capabilities and enhanced client experience capabilities will widen the path to success. The bottom line is it will be hard to travel too far down any of the paths unless the investment manager is fully committed to the journey. It will be bumpy, but those who stay the course and provide investors with viable ETF investment options and education will be rewarded.

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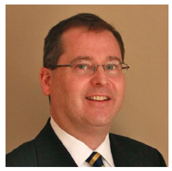

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