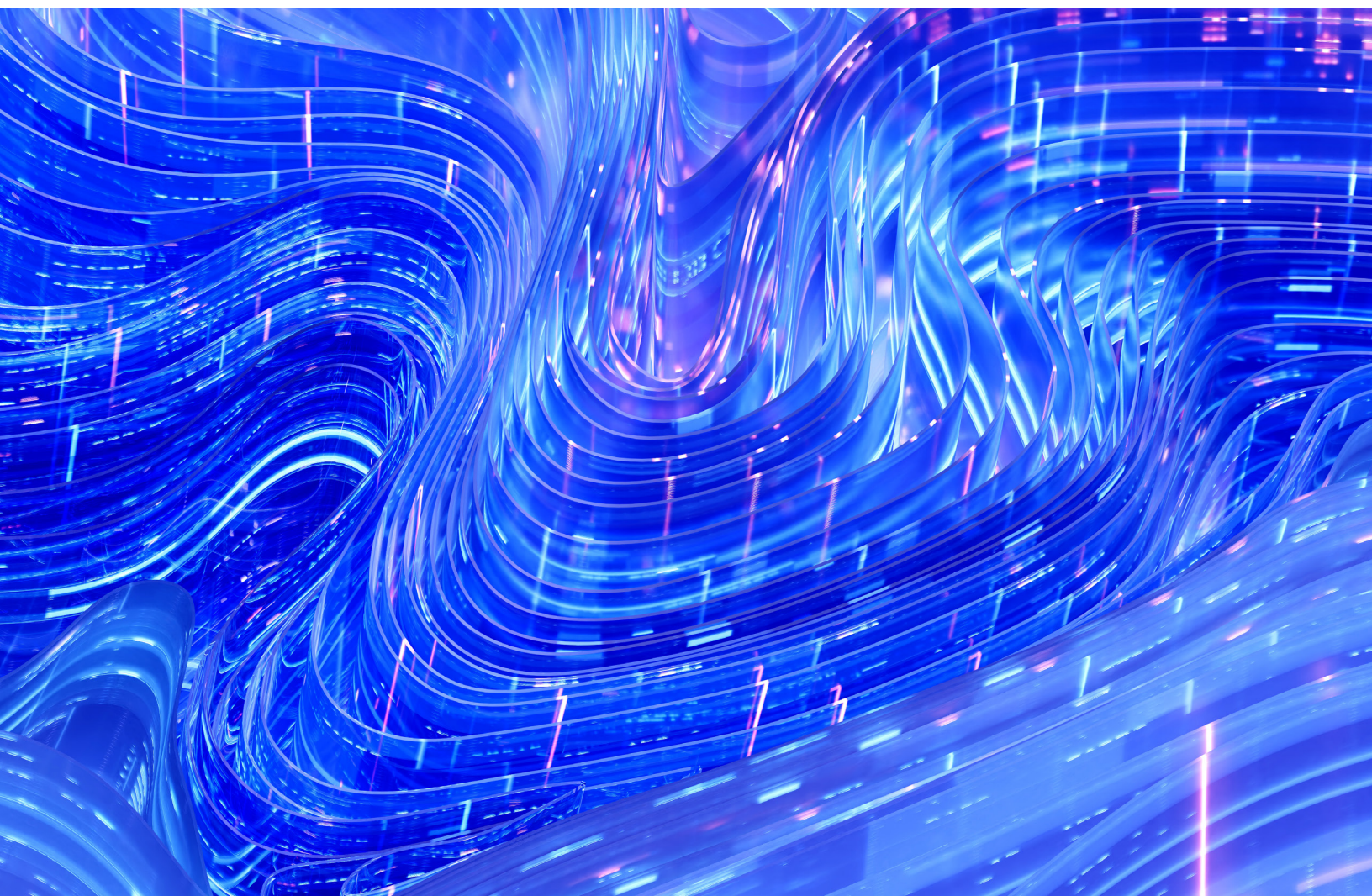




ETF SHARE CLASS OF A MUTUAL FUND

# A guide to the next wave of ETFs

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# Introduction

**Earlier this year, our ETF product team published its annual Global ETF Outlook for 2025, highlighting ETF share classes of mutual funds as an emergent topic in the United States.**

While these share classes exist in multiple jurisdictions around the globe, in the US they have been limited to one fund sponsor (Vanguard) offering ETF classes of passive index mutual funds.

That, however, is about to change.

When the patent for Vanguard's ETF share class structure expired in May 2023, 62 fund managers (at the time of this writing) filed for regulatory approval to expand the structure to active management, semi-transparent active, and the addition of a mutual fund class to an existing ETF.

This paper explores the main features of the filings, taking a more granular look into the exchange privilege, the benefits to all participants impacted, and critical considerations for providers, custodians and the broader ETF ecosystem.

## **The SEC has prioritized ETF share class this year**

In remarks at a March Investment Company Institute conference, then-acting Securities and Exchange Commission (SEC) chair Mark Uyeda said he had directed staff to prioritize review of ETF share class applications, leading to further discussion and expanded filings from fund managers.

This activity has boosted optimism, shared by State Street's ETF product team, that the US ETF industry could not only see an approval in the calendar year of 2025, but also an ETF class launch.

# Key features and considerations of share class filings

**The filings allow active fund managers to add an ETF class to an existing mutual fund.**

The expectation is that the fund will align with the standards set by ETF Rule 6c-11, approved in 2019, including full transparency, ability to utilize custom baskets, and other website reporting requirements.

In addition, fund sponsors will be required to provide enhanced board oversight, reporting, and disclosures. This board oversight may include firm-specific surveillance to board approved preset thresholds.

**There are important considerations for a board prior to approving the structure, including:**

**1**

Impact of daily portfolio transparency

**5**

Potential for any cross-subsidization

**2**

Potential capacity constraints as ETFs are open ended and cannot be closed to new investors

**6**

Frequency of enhanced board reporting and analysis of thresholds

**3**

Impact of ETF class capabilities (in-kind mechanism, exchange trading, cost benefits) to the overall fund and other classes

**7**

Existing funds unrealized and realized tax position (special distributions should be considered to avoid the ETF having a realized tax position on day one)

**4**

Shareholder makeup and potential volume of initial shareholders participating in the exchange privilege

Post-board approval and launch of the structure, ongoing board reporting will be required. Board reporting should include numerical, pre-approved thresholds, and describe how the fund and its classes performed against those thresholds.

Boards will decide if there is the need for any actions associated with exceeding thresholds, although both board and advisor should consider a pre-determined list of potential remedial actions.

#### Critical elements of board reporting include:

1

Exchange privilege volume and impact, if any

6

Description of any threshold exceeded over the prior period

2

Impact to cash drag in the mutual fund class as well as to the ETF class

7

Traditional ETF metrics

- Distributor report including primary market volumes and activity
- Investment advisor report on ETF trading including: Premium/discounts, bid/ask spreads, trading volumes, and detailed primary market activity specifically tied to custom basket usage and outcomes

3

Impact to long- and short-term capital gains

4

Performance differences among classes

5

Negative impact of the operating model to either class



# Gauging the benefits and impacts for fund managers

Active ETF assets in the US exceeded \$1 trillion in the first quarter of 2025 with net inflows of \$120 billion.<sup>1</sup> Compare that with net outflows in the US mutual fund industry of \$205 billion in the same time period and it's no surprise that traditional fund managers are analyzing how and when they should enter the ETF space.<sup>2</sup>

Historically, there have been three paths of entry into the ETF marketplace for a traditional active manager:

1. **Build:** Launch a standalone ETF franchise
2. **Buy:** Purchase an ETF manager which brings talent, tools, and experience to your firm
3. **Rent:** Utilize an ETF white label or ETF-as-a-service offering to gain access into the ETF industry with support and reduced upfront cost

The ETF share class of a mutual fund is the fourth entry point to the ETF marketplace, and many asset managers view it as the most efficient option. Every asset manager contemplating the ETF market using the share class path to entry must consider cost, brand, existing capabilities, organizational buy-in and asset ramp-up to determine if size, track record and liquidity meet distribution partner thresholds.

All of this entails financial cost, the risk of cannibalizing existing non-ETF assets, and the opportunity cost of inaction. The ETF share class is an elegant solution to launch the fund at scale, with a more efficient operational structure and an established track record. However, concerns remain around capabilities and buy-in. Notably, 13 of the 62 filers to date do not currently offer ETFs in the US, which could increase ramp-up costs.

Fund sponsors must weigh the potential benefits and disadvantages of the structure to align on net benefits to all classes and the fund as a whole prior to moving forward with an ETF class ([Exhibit 1. A closer look at the benefits versus the disadvantages](#)).

<sup>1</sup> ETFGI

<sup>2</sup> ICI Q1 Mutual fund flows

## Exhibit 1: A closer look at the benefits versus the disadvantages

### ETF class



#### Potential benefits

- Access to established strategies bringing with them a historical track record as well as scale and diversification on day 1
- Potential for additional liquidity from the increase in ETF shareholders via the exchange privilege
- Potential capital loss carry-forward that would be available to both classes
- Additional flexibility with the cash subscription/redemption process within the mutual fund class or cash on hand within the mutual fund.



#### Potential disadvantages

- Single set of accounting policies: Once in a share class structure, ETF-only accounting policies (fair valuation, expense forecasting, accrual policies) become difficult
- ETF class may not be ideal for a strategy with varying capacity constraints. The ETF cannot close to new investors without massive impacts to pricing and execution quality

### Mutual fund class



#### Potential benefits

- Potential for increased tax efficiency from the primary market in-kind capability of the ETF
- Additional flexibility with ETF class custom basket process
- The exchange privilege provides an efficient path for investors to move into the ETF from the mutual fund without creating potential gain/loss impacts to the mutual fund
- Potential for reduced cash drag



#### Potential disadvantages

- The mutual fund class will now be fully transparent daily via the ETF. This will add additional analysis on funds that would be in scope for the dual class structure. Chief investment officers and boards will need to be comfortable that daily transparency does not negatively impact the fund or shareholders

## Fund sponsor



### Potential benefits

- Greater efficiency in operating model: A single fund with multiple investment wrappers to efficiently access additional distribution channels
- Cost effective
- Scale and track record on day 1 will allow funds to leap over initial asset/track record hurdles that exist for brand new standalone ETFs
- Exchange privilege provides an efficient path for fund sponsors to retain existing investors that are happy with the strategy but want the strategy in an ETF (Intraday liquidity, cost effective)



### Potential disadvantages

- Operational complexity of the exchange privilege
- Economic incentive impacts of the intermediary/wealth platforms of shareholders moving from mutual fund to ETF. How will the intermediaries be made whole?
- Reg-BI impact to the intermediary platforms of having the same strategy in a mutual fund and an ETF with potential differing costs
- Distribution schedules across mutual funds and ETFs and the expected timings for distribution communications to the exchange.
- Review of fund-level accruals that would need to be moved to a class level accrual (Blue Sky, Transfer Agency)

## Investor



### Potential benefits

- Intraday access to established strategies that trade digitally
- Potentially reduced overall cost of ownership
- Transparency
- Ability to better tax manage based on account type/investment reasons
- ETF-intraday liquidity with no minimum investment (outside one full share of the ETF)



### Potential disadvantages

- Potential unknowns around the impact of ETF classes to mutual fund rights of accumulation
- ETF spreads may increase on day one for ETF classes until the market making community gains comfort with pricing/hedging
- ETF dividend reinvestment mostly occurs on the broker/dealer platform and not always instantaneous
- ETFs typically do not have an auto invest/divest capability (fractional shares limitation)



# The art of the exchange privilege

**The exchange privilege is a key feature of the ETF share class structure in the US today. The existing model is bespoke to Vanguard who currently plays multiple roles associated with the operational nuances of the exchange privilege. As a result, an industry-wide, automated solution will be needed to enhance efficiency and speed, and deliver a strong client experience for end investors.**

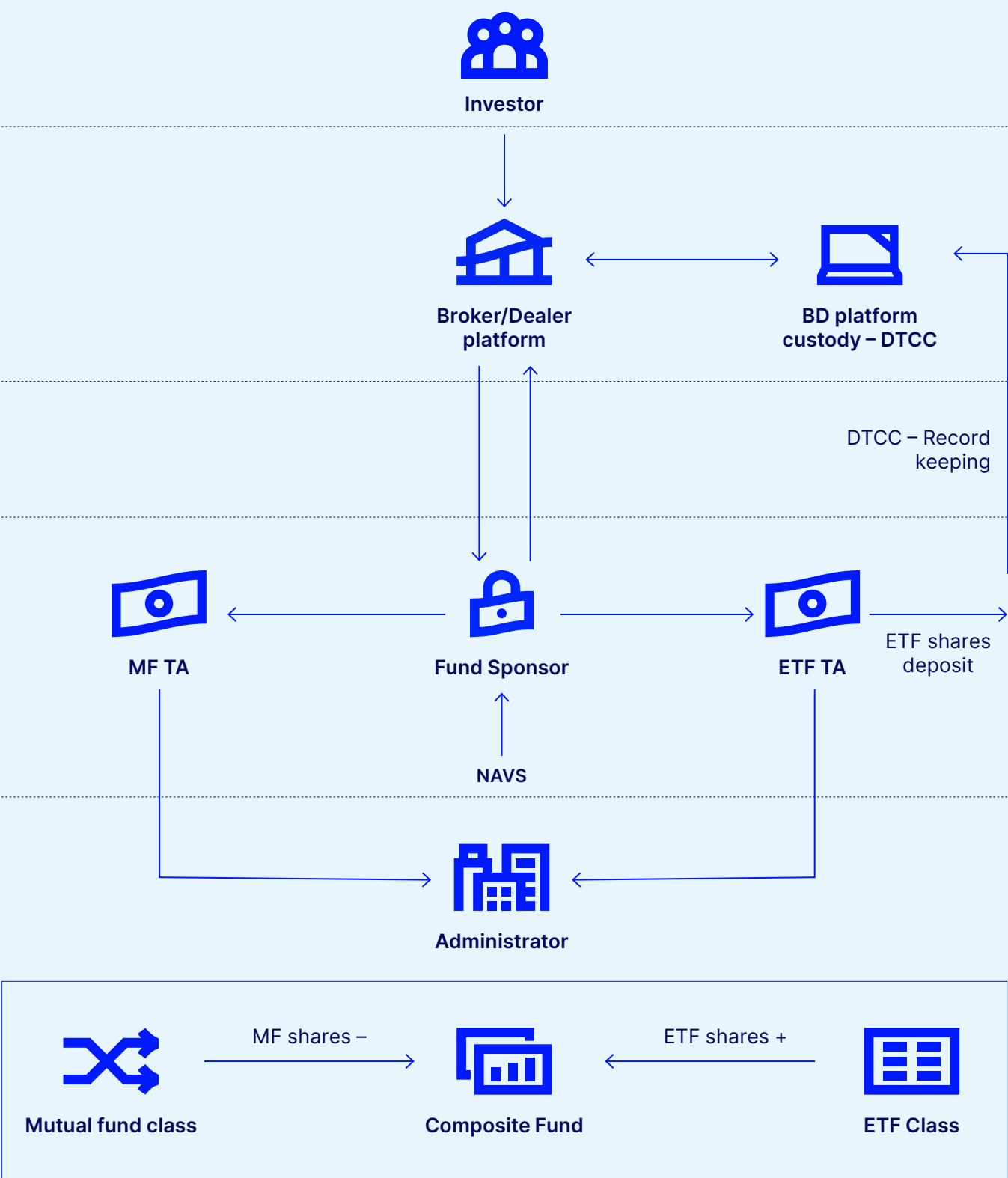
There are various groups and sub-groups currently working with key business leaders across custodians/administrators, transfer agents, fund sponsors, broker/dealer platforms and industry stakeholders to develop this industry solution.

At the time of writing, the working groups had outlined three potential models, each reflecting a different level of automation: (1) a fully manual model, (2) a model with automated communications only, and (3) a fully automated industry utility model.

In most cases, the approval timeline for the structure is expected to move faster than the pace at which stakeholders can implement system enhancements — especially given that the model is still being designed with built-in optionality.

For a detailed breakdown of the exchange privilege process and key considerations, see [Exhibit 2. A closer look at exchange privilege.](#)

Exhibit 2: A closer look at exchange privilege





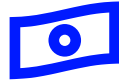
**Investor:** Requires a communication protocol to the brokerage firm to instruct an exchange. The exchange would be supported as a mutual fund class dollar amount or a share quantity to be exchanged into equal value of the ETF class.



**Mutual fund transfer agent:** Will take down mutual fund shares as a redemption in-kind vs. zero. The mutual fund transfer agent may also receive back residual quantity of mutual fund shares or cash to create the equivalent value of ETF shares which are required to be whole shares.



**Broker/dealer platform:** Requires the ability to manage the inbound requests and communicate to the fund sponsors the intended mutual fund leg of the transaction as well as any settlement instructions for the ETF leg settlement.



**ETF transfer agent:** Deposits new shares of the ETF to Depository Trust and Clearing Corporation (DTCC) and instructs delivery free-of-payment to the custody instructions of the end investor at their broker dealer.



**Fund sponsor:** Orchestrates the communication between the mutual fund transfer agent and ETF transfer agent. There is sequencing involved as the mutual fund leg must be normalized to a consistent dollar value prior to the ETF transfer agent booking on the ETF leg equivalent value. Both values are based on official net asset value (NAV) at the end of business on the same request execution date.



**Administrator:** Processes accounting capital stock entries on both the mutual fund class (reduction of shares) and ETF class (increase of shares). The only metrics that change as a result of an exchange are the share outstanding of each class, the market value of each class, and the allocation ratio of each class. No change to the fund.

Within the exchange privilege, there are numerous considerations and decisions to be made by both the fund sponsor and broker/dealer platforms.

#### **For fund sponsors:**

- Availability of exchange privilege for all funds/classes into the ETF
- Blackout dates around distributions
- Frequency the exchange is available prior to industry automation
- Potential consideration if distribution partners ask the fund sponsor to pick one of the wrappers (mutual fund and ETF) to be on platform

#### **For broker/dealer platform:**

- Support and frequency of exchange privilege
- Client position freeze from point of exchange request through settlement
- Timing for settlement prior to industry automation – client experience impacts
- Reg BI, suitability concerns must be worked through to determine offering or if mass exchange to the ETF
- Potential revenue implications to historic business model

**“The approval timeline for the structure is expected to move faster than the pace at which stakeholders can implement system enhancements — especially given that the model is still being designed with built-in optionality.”**

# Conclusion

## State Street has the essential building blocks in place to support the growth of an ETF share class.

The question we're most frequently asked is whether we (as a custodian and administrator) can support the ETF share class. Our answer is a resounding "yes"! After having read the filings, been active members of all working groups, and having prepared for this moment for the past few years, we have a checklist firmly in mind:

1. The accounting structure must function to cover the nuances of the share class structure and the nuances of the ETF structure
2. Basket production must be flexible enough to support a single pool of assets where the ETF is only allocated a portion on a pro rata basis
3. The ETF transfer agent must have the ability to deposit and process shares in sub units to support the exchange process
4. The settlements/clearance function and systems must be able to support both classes simultaneously across the differences in how flows operate

At State Street, we utilize a single proprietary global system to support both mutual funds and ETF accounting and custody. We support ETF share class in its current form in the US and other jurisdictions globally, and have enhanced our technology stack to support outsourced basket production.

What's more, we are continuing to ask ourselves tough questions. What will the final exemptive approval include? What will fund sponsors request from their service partners that is net new? What impact will service demands have on launch timelines?

As we answer these and other questions as they arise, we will continue to support clients and the ETF industry in this important wave of innovation.

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