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Share Class Structures for Mutual Funds/ETFs: How Fund Groups Can Begin Preparing for Anticipated SEC Exemptive Relief

ROPES & GRAY

Table of Contents

When the SEC grants the Share Class Relief, applicant Funds will need to consider a number of important matters before relying on it.[2] This white paper provides a brief summary of the proposed Share Class Relief and highlights a number of key legal, governance, compliance and operational considerations for a Fund seeking to rely on the Relief for the first time. Although the SEC has yet to grant the Share Class Relief for any applicant[3] and there is no assurance that it will ultimately do so, Fund sponsors may want to move quickly to launch new ETF or Mutual Fund Classes once relief is available. Investing time now in laying the groundwork for these new share class structures could pay dividends by significantly expediting launch.

While the discussion below is intended to serve as a useful reference point, 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 ETFInnovations@ropesgray.com.

I. Introduction

This white paper is intended to guide and inform registered funds, their sponsors and other service providers and their boards ("Boards") as they prepare to take advantage of potentially forthcoming exemptive relief (the "Share Class Relief" or the "Relief") from the Securities and Exchange Commission ("SEC"). When granted, the Share Class Relief is expected to permit, subject to certain conditions, 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").[1]

While the SEC has not yet granted the Share Class Relief, to date the SEC has received over 50 applications from Mutual Fund and ETF sponsors across the industry, collectively representing trillions of dollars in Fund assets under management. Ropes & Gray represents many of these applicants and has been actively engaging with the SEC staff on pending applications and with various industry participants to prepare the operational and compliance framework that will be required to implement the Relief. When granted, the Share Class Relief has the potential to transform the landscape for cost-efficient access to, and distribution of, investment strategies to a broad universe of investors using both Mutual Fund and ETF channels.

II. The Share Class Relief

The Share Class Relief is expected to allow a Mutual Fund to offer a class of ETF Shares (in addition to one or more classes of Mutual Fund Shares) and an ETF to offer one or more classes of Mutual Fund Shares (alongside a class of ETF Shares).[4] Any Fund offering ETF Shares under the Relief, as currently contemplated, would enjoy the same relief provided by, and be subject to the same conditions contained in, Rule 6c-11 under the Investment Company Act of 1940, as amended (the "1940 Act"), with respect to the operation of the ETF Shares.[5] In addition, we expect the Relief to allow Funds to offer an exchange privilege that would permit holders of Mutual Fund Shares to exchange their shares for ETF Shares, but not vice versa (the "Exchange Privilege").[6]

The Share Class Relief would open a new avenue for sponsors of Mutual Funds to sell existing publicly offered strategies in an ETF wrapper and ETF sponsors likewise to utilize the Mutual Fund wrapper for existing ETFs, in each case with lower overall organizational and on-going operating costs than forming a new stand-alone fund. The more flexible share class structure would enhance investor choice and could provide significant benefits to both Mutual Fund Class and ETF Class shareholders. These benefits would likely include cost savings through economies of scale, reduced shareholder transaction costs, more efficient portfolio management, less disruption from frequent trading by Mutual Fund shareholders, greater arbitrage efficiency and narrower spreads for ETF Shares, and significant tax advantages.

While the Share Class Relief would be novel in some respects, it is not without precedent. In particular, in 2000 the SEC granted relief to The Vanguard Group, Inc. ("Vanguard") to offer an ETF Class in index mutual funds, and Vanguard Funds have been operating under that relief (and several related exemptive orders granted in the intervening years) for over two decades.[7] To date, the SEC has not granted similar relief to any other Fund group.[8] The proposed Share Class Relief would differ from the Vanguard relief in various ways, including that it would apply more broadly to both active and passive strategies.

The Share Class Relief is expected to require compliance with a number of conditions.[9] In addition, a variety of operational challenges will likely need to be addressed before a Mutual Fund would be ready to go live with ETF Shares (or an ETF with Mutual Fund Shares). The remainder of this white paper summarizes important considerations for Fund sponsors, other Fund service providers and Fund Boards before a Fund begins relying on the Relief to launch new share classes. Many applicants with pending exemptive applications are continuing to engage with the SEC staff on the scope and specific conditions of the Relief, and, therefore, the final form the Relief will take is still an open question. That said, there are certain features of existing applications that we expect to appear in any final Relief. We focus on those below.

III. Considerations Before Launch

A. The Board's Best Interests Determination

Under the proposed Share Class Relief, before a Fund offers both Mutual Fund Classes and an ETF Class, a Board, including a majority of its independent members, must find that the "multi-class structure is in the best interests of each Mutual Fund Class and ETF Class individually and of the Fund as a whole."[10] Boards will be expected to consider a range of factors in making this determination and will rely on the Fund's investment adviser (the "Adviser") in collaboration with other Fund service providers to provide appropriate information to assist the Board in weighing each factor as it considers making the required "best interests" determination.

In its adopting release for Rule 6c-11, the SEC expressed concern that an ETF Class that transacts with authorized participants (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.[11] That is, since Mutual Fund Class shareholders will typically transact in cash, while ETF Classes will typically transact in-kind, a Fund may need to buy (or sell) portfolio securities to process Mutual Fund Class purchases and redemptions, incurring costs along the way.[12] 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 daily redemptions from a Mutual Fund Class. The costs to the Fund of holding additional cash or low-yield liquid assets ("cash drag") would be borne by the Fund's shareholders as a whole (including holders of ETF Shares). These and other concerns related to fairness among holders of different classes of shares give rise to a number of specific areas that might merit 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.[13]

The below tables present our preliminary observations as to factors that may be relevant for a Board's initial assessment of a new share class proposal in reliance on the Relief and offers some suggestions for ways in which an Adviser, with support from other Fund service providers, could help facilitate Board consideration of each factor. While these observations are informed by currently pending applications and our discussions with the SEC staff, they should be reconsidered in light of any final conditions set forth in the Share Class Relief.

FACTOR FOR ADVISER AND BOARD CONSIDERATION	POTENTIAL ANALYSIS
Expected Benefits of Economies of Scale	■ Estimate the size of the potential market opportunity, and provide net sales projections, for a new ETF Class or Mutual Fund Class and estimate potential reductions in certain fixed costs (measured in basis points) if the Fund is able to grow to meet these projections.[14] — 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. — For some Fund groups, an ETF Class may be the most effective avenue for gaining access to the self-directed individual retail channel and to clients of registered investment advisers who prefer to utilize ETFs. — Adding a Mutual Fund Class of an existing ETF may help the Fund access the retirement or "401(k)" distribution channel. — 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. ■ 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. — While some platforms that have been reluctant to offer a "clone" Fund (based, in part, on concerns under applicable regulatory standards of conduct[15]) might be open to 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.
Cost Savings Associated with having a Single Fund and Potential Fund Costs Associated with Launch	■ 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, custody and other arrangements). ■ 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 expenses.[16] ■ 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). ■ 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, how those documents can be amended to accommodate the structure (which may, in some cases, 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.

FACTOR FOR ADVISER AND BOARD CONSIDERATION	POTENTIAL ANALYSIS
Ability to Utilize the Track Record of an Existing Fund or Class	■ 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. ■ 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.
Comparative Features and Fee Structures of the Classes	■ ETFs have historically operated under a unitary fee structure. Analyze whether a unitary fee structure remains appropriate when a Fund has both an ETF Class and one or more Mutual Fund Classes. — 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.[17] — 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.
Ability to Engage in More Frequent Trading through an ETF Class	■ 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, since ETF Class transactions in the secondary market will not result in portfolio transaction costs for the Fund. — Historical data on Mutual Fund shareholder trading behavior could be helpful for this analysis.

FACTOR FOR ADVISER AND BOARD CONSIDERATION	POTENTIAL ANALYSIS
Potential for Cross-Subsidization	▪ Prepare a monitoring framework to identify and assess potential cross-subsidization, including to inform periodic reporting to the Board on the potential benefits and costs of the structure to the Fund and each of the ETF Class and Mutual Fund Classes and preview this framework with the Board in connection with any proposal to implement a structure in reliance on the Share Class Relief. ▪ Consider the feasibility of allocating any material servicing costs that are incurred differently by ETF Shares and Mutual Fund Shares separately to such shares. — 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. ETFs also pay initial listing fees to the exchange and annual fees to maintain the listing, and may pay market-maker incentive fees. — 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. ▪ 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 processes only in-kind creations and redemptions.[18] ▪ 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. ▪ 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. — One measure a Fund might utilize to address any material cross-subsidization concerns related to these costs would be the imposition of purchase premiums and/or redemption fees on cash transactions for Mutual Fund Classes. In that regard, the Adviser and the Board might also assess, in connection with proposing the new share class structure, the operational feasibility of imposing such fees.[19] ▪ Consider the feasibility of quantifying Fund brokerage and other trading costs on a class-by-class basis after launch.[20]

FACTOR FOR ADVISER AND BOARD CONSIDERATION	POTENTIAL ANALYSIS
Tax Impacts	▪ 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. —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. — Also consider the availability of existing capital loss carryforwards to offset any realized gains in the future. ▪ 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. — 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. — 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). ▪ 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 any direct benefit from a more efficient tax structure).
Appropriateness for the Fund's Investment Strategy	▪ Assess whether a Fund's strategy may be subject to capacity constraints and how those constraints might be managed as the Fund grows. — For Mutual Funds launching an ETF Class, assess how capacity constraints will be managed given that, unlike Mutual Funds, an ETF cannot ordinarily reject all purchase orders when the Fund nears capacity.[21] — 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. — Consider whether existing investment strategies could, consistent with the best interests of existing shareholders, be modified to address potential capacity issues, if necessary. ▪ For a Mutual Fund considering offering an ETF Class, consider whether daily portfolio transparency is compatible with the Fund's investment strategy.[22]
Impact of Secondary Market Transactions	▪ For Mutual Funds, the addition of an ETF Class will mean that a class of Fund shares will be available for short-selling. ▪ To the extent ETF Shares trade at a market price that reflects a premium or discount to NAV, such trading may impact purchases and sales of Mutual Fund Classes.

B. Other Operational Considerations

Fund sponsors and Boards will also need to understand and grapple with the potential operational hurdles presented by Share Class Relief. Funds seeking to rely on the Share Class Relief should begin having conversations with their service providers (*e.g.*, custodians, administrators, transfer agents, principal underwriters, auditors) as well as the sponsors of the platforms through which the Funds will be sold well in advance of the date they intend to launch a new share class in reliance on the Relief.

We expect that it may prove operationally challenging to gather the sorts of data necessary for initial Board approval (as discussed above) and to develop systems that would facilitate the ongoing monitoring required by the Share Class Relief (as discussed below). In addition, ETFs have historically used a different set of industry service providers than Mutual Funds for various back-office functions (or different teams within those service providers). As a result, coordinating Fund back-office services (*e.g.*, custody, transfer agency, fund administration and accounting) for a Fund offering both Mutual Fund and ETF Classes may involve making sure that the various systems and teams used to support the different classes can work together smoothly. In addition, the ETF ecosystem relies on other participants that are not required for Mutual Fund shares, including Authorized Participants, market makers and other liquidity providers, listing exchanges and the Depositary Trust Company ("DTC"), which may add to the complexity of operating a Fund relying on the Relief.

IV. Considerations After Launch

A. Potential Areas for Ongoing Monitoring and Reporting

After initial approval, the Share Class Relief would also require ongoing monitoring and Board reporting to ensure that the arrangement remains in the best interests of each class and the Fund as a whole. Advisers should be prepared to establish processes for the periodic collection of the relevant data. The table below highlights some potential areas for Adviser monitoring (and subsequent Board reporting).

Issue	Impact on a Fund and Its Shareholders	Relevant Data
Cash Drag	Housing Mutual Fund and ETF shareholders in a single vehicle introduces the possibility that ETF shareholders might be harmed (or benefited) by the Fund's increased holdings of cash or cash instruments (relative to a similarly managed standalone ETF).[23] Counter-balancing this concern will be the potential benefit to the Fund's shareholder base as a whole of having short-term reserves and cash flows in the portfolio to help make distributions to shareholders, pay Fund fees and expenses, construct baskets for creations/redemptions or rebalance the Fund's portfolio.[24]	Advisers should plan to gather and provide data on the amount of cash and other liquid instruments the Fund has held in recent periods to meet Mutual Fund Class redemptions, how this level of liquid holdings would likely compare to the cash maintained by a similarly-managed standalone ETF, and how market movements during the period have created "drag" (in up markets) or contributed to performance (in down markets) for the Fund.[25] If applicable, this reporting should also include the costs of any credit facility maintained to help manage redemptions efficiently and how those costs are allocated by class.[26] Reporting should address how these costs might be offset by advantages for portfolio management or Fund operations of regular cash flows. Advisers should also expect to report on the Adviser's efforts to equitize the cash in the Fund (*e.g.*, through derivatives) and any costs or impacts on returns associated with cash equitization.

Issue	Impact on a Fund and Its Shareholders	Relevant Data
Tax Efficiency	The entire shareholder base will benefit from the tax efficiencies inherent in the ETF in-kind create/redeem mechanic.[27] Counterbalancing this benefit to some extent is the potential for cash redemptions in Mutual Fund Classes to generate distributable capital gains.	Board reporting might include a comparative analysis of how these distributions have been impacted by the Fund's class structure, including reporting on unrealized capital gains on securities distributed in in-kind redemptions in the ETF Class.
Shareholder Flows and Trading Volume	As noted above, managing purchase and redemption transactions of Mutual Fund Shares may cause a Fund to incur brokerage and trading costs or implicit costs in the form of cash drag. While new Board reporting might be developed to help the Board understand these costs, it will be helpful for the Board to have increased visibility into overall Fund flows on a class-by-class basis.	Advisers should consider presenting class-by-class data on flows into and out of Mutual Fund Classes alongside data on trading volumes in both the primary (creations and redemptions) and the secondary market for the Fund's ETF Shares.[28] For Mutual Funds adding an ETF Class, comparative data showing changes in shareholder flow trends (before/after the launch of the ETF Class), and the level of Mutual Fund Class-to-ETF Class exchanges, may help Boards understand how shareholders are utilizing the flexibility to invest in the Fund through both channels.
Spreads	The ETF Class will be subject to requirements under Rule 6c-11 that the Fund monitor bid-ask spreads and take appropriate corrective action in certain circumstances.	Board reporting on bid-ask spreads may be accompanied by additional analysis of shareholder utilization of the Exchange Privilege or other trends in shareholder flows. This would help Boards understand whether and to what extent trends in spreads are impacting shareholder trading decisions and what effect, if any, the share class structure is having on arbitrage efficiency and narrower spreads on the trading of ETF Shares in the secondary market.
Brokerage and Trading Costs	Cash flows into and out of the Mutual Fund Class may trigger portfolio transactions and associated costs in order to put newly received cash to work or to meet shareholder redemption requests. In contrast, ETFs typically transact in kind, which means brokerage and other costs are externalized and not borne by the Fund.[29]	Existing Board reporting on brokerage and trading costs might be enhanced to show brokerage costs or other trading costs driven by class-level purchase and redemption activity.[30] The reporting might attempt to match outflows from the Mutual Fund Classes to sales of portfolio securities and their associated costs (or otherwise show how these redemptions were honored—*e.g.*, through Fund cash holdings or by utilizing a credit facility).[31] While it may not be possible to identify these costs with certainty (*e.g.*, because flows from different classes may offset each other, or because a Fund may buy and sell portfolio securities for portfolio management reasons at times when there are cash purchases or redemptions by Mutual Fund Class shareholders), such Board reporting could discuss the uncertainties and assumptions made in connection with such estimates.[32]

B. Corrective Actions

A Fund and its Adviser will also want to be prepared to take corrective measures (with Board discussion and, where appropriate, Board approval) should the Board determine, based on an analysis of the factors noted above, that the new share class structure may no longer be in the best interests of each class and the Fund as a whole. Potential actions may include:

- Altering, adding, or discontinuing any conditions of purchase (including eligibility requirements), redemption, exchange, conversion, and dividend reinvestment or other services or privileges for Mutual Fund or ETF Shares
- Imposing, discontinuing, altering or waiving any purchase fee, redemption fee, account service fee, or other fee charged to a shareholder or a group of shareholders
- Modifying the Fund's investment strategy
- Liquidating or combining one or more classes or the Fund
- Restructuring a Fund's ETF Class or Mutual Fund Class as shares of a separate Fund that offers only an ETF Class or one or more Mutual Fund Classes but is otherwise identical to the Fund.[33]

Prior to launching new classes in reliance on the Share Class Relief, Advisers should consider the feasibility of remedial measures of the sort 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 the potential operational challenges associated with taking these remedial steps, the expected timeframe required to implement them, as well as 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.

V. 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 authorized participants, 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 authorized participants, 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.
- 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.

The Share Class Relief, if provided by the SEC, would represent an exciting opportunity for Fund sponsors to expand their existing ETF and Mutual Fund 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 Funds, their sponsors and their Boards, navigate them. Please reach out to your regular Ropes & Gray contact or contact us at ETFInnovations@ropesgray.com.

Endnotes

[1] There is some variation among the pending exemptive applications, including with respect to the material representations made and the conditions proposed, as discussed further below (*see* endnote 5 below). While it is possible that the SEC grants multiple versions of the Share Class Relief with different conditions, in recent instances where the SEC has granted novel exemptive relief, the staff has worked with applicants to standardize the applications before granting the requested relief. We believe it is likely that the staff will take a similar approach with respect to the Share Class Relief.

[2] Although an exemptive order appears to be the most likely approach to allowing Mutual Funds to offer an ETF Class and ETFs to offer Mutual Fund Classes, it is possible that the SEC staff could determine that its delegated authority allows it to act through a no-action letter. Alternatively, the SEC could propose and adopt a new exemptive rule or amendments to an existing exemptive rule, or grant exemptive relief in the form of "class relief" (e.g., granting any ETF relying on Rule 6c-11 exemptive relief to operate a Mutual Fund Class, and any Mutual Fund exemptive relief to operate an ETF Class, subject to a set of standardized conditions). Unlike exemptive orders, which can be relied upon only by the particular applicants and certain specified categories of affiliates, an exemptive rule or "class relief" could be relied upon by any Fund that complies with the conditions of the rule or relief.

[3] As noted below (*see* endnote 7 below), the Vanguard Group, Inc. obtained a form of Share Class Relief in 2000.

[4] While each of the pending exemptive applications for Share Class Relief seeks relief necessary to offer both ETF Shares and Mutual Fund Shares, some applications request relief only for a Mutual Fund to add ETF Shares, some request relief only for an ETF to add Mutual Fund Shares, and some request both.

[5] Note that some pending exemptive applications request relief that would permit a Fund with both an ETF Class and one or more Mutual Fund Classes to offer ETF Shares in reliance on existing semi-transparent ETF exemptive orders and therefore not be subject to the condition contained in Rule 6c-11(c)(1)(i) requiring daily disclosure of each portfolio holding. The SEC staff has indicated that, in its view, requests involving semi-transparent ETFs raise different issues and should not expect to be processed on the same basis as Rule 6c-11-based requests. We also note that, since a Fund with an ETF Class may be viewed as not technically complying with Rule 6c-11 (it would only comply with the rule with respect to the ETF Class), it may be necessary for listing exchanges to seek SEC approval of technical changes to their listing rules (which currently refer to compliance with Rule 6c-11 to meet generic listing standards). Funds that are able to rely on Rule 6c-11 are listed for trading pursuant to NYSE Arca Rule 8.600-E, Cboe BZX Rule 14.11, or Nasdaq Rule 5704. In addition, it may be necessary for the SEC to extend existing class relief under the Securities Exchange Act of 1934 (the "Exchange Act") that is currently available to ETFs that comply with Rule 6c-11. *See* Order Granting a Conditional Exemption From Exchange Act Section 11(d)(1) and Exchange Act Rules 10b-10, 15c1-5, 15c1-6, and 14e-5 for Certain Exchange Traded Funds, https://www.sec.gov/files/rules/exorders/2019/34-87110.pdf. Note that in April 2024, Cboe BZX Exchange, Inc., ("Cboe"), filed an application with the SEC proposing amendments to Cboe Rule 14.11(l), which sets forth the "generic" listing standards applicable to the listing and/or trading on Cboe of ETFs that operate in reliance on Rule 6c-11. See our alert available here: https://www.ropesgray.com/en/insights/alerts/2024/04/cboe-proposes-rule-changes-related-to-etf-share-class-relief. On February 28, 2025 the SEC announced that it was deferring action on the proposed rule change until May 2, 2025. On March 11, 2025, Cboe filed an amendment to its 19b-4 application, proposing to adopt new Rule 14-11(n), instead of amending existing Rule 14-11(l), to permit the generic listing of ETF Shares. The amended application includes significantly more discussion about the purpose and rationale for the proposed changes.

[6] A small number of pending exemptive applications request relief for an exchange privilege that would operate in both directions (*i.e.* allowing exchanges of Mutual Fund Shares for ETF Shares *and* exchanges of ETF Shares for Mutual Fund Shares). This white paper does not address in detail considerations that may be unique to a Fund that seeks to operate with such a bilateral exchange privilege, should the SEC grant Relief including that feature. As used in this white paper, "Exchange Privilege" means a one-way privilege to exchange Mutual Fund Shares for ETF Shares (but not vice versa).

[7] Vanguard Index Funds, Investment Company Act Release Nos. 24680 (Oct. 6, 2000) (notice) and 24789 (Dec. 12, 2000) (order); The Vanguard Group, Inc., Investment Company Act Release Nos. 26282 (Dec. 2, 2003) (notice) and 26317 (Dec. 30, 2003) (order); Vanguard International Equity Index Funds, Investment Company Act Release Nos. 26246 (Nov. 3, 2003) (notice) and 26281 (Dec. 1, 2003) (order); Vanguard Bond Index Funds, Investment Company Act Release Nos. 27750 (Mar. 9, 2007) (notice) and 27773 (April 2, 2007) (order). We note that the vast majority of Vanguard ETF assets under management are attributable to ETF Share Classes of Funds that also offer a Mutual Fund Class, rather than stand-alone ETFs.

[8] Until recently Vanguard held a patent on this share class structure. It has been reported that this patent protection expired in May of 2023. While we understand that several firms have licensed the structure from Vanguard and applied for similar relief over the years, the SEC declined to grant relief. *See, e.g.*, https://www.sec.gov/Archives/edgar/data/732910/000119312516594242/d183837d40appa.htm. In addition, while Vanguard sought to extend their exemptive relief to actively managed Funds, the SEC also declined to grant the relief. *See* https://www.sec.gov/Archives/edgar/data/34066/000093247115007273/activeetfapp_amend3clean.htm.

[9] Many of the currently contemplated conditions/material representations would not pose particularly thorny operational or interpretive issues. For example, all references to the ETF Shares will use a generic term such as "ETF" in connection with such shares, or a form of trade name indicating that the shares are exchange-traded, rather than the Fund name; there will be separate prospectuses for a Fund's ETF Shares and Mutual Fund Shares; and various other disclosure requirements intended to avoid investor confusion.

[10] Mutual Fund Boards will be familiar with this standard as it mirrors the standard that has long been applicable to the approval of a multi-class plan pursuant to Rule 18f-3 under the 1940 Act. *See* Rule 18f-3(d).

[11] For the sake of simplicity, this white paper 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 (and certain applications only request relief for cash creations and redemptions involving ETF Shares), the considerations outlined below come into sharper relief when set against the background of this basic structural difference between the classes.

[12] These costs, which typically would be greater than those incurred with respect to transactions in ETF Shares, may include brokerage and execution costs, but also, in some cases, the second-order costs associated with the realization of capital gains when an appreciated security is sold (resulting in distributions to shareholders, given a Fund's distribution requirements as a regulated investment company).

[13] 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 class structure, which should inform shareholders of the key differences between Mutual Fund and ETF Classes, and alert them to the potential disadvantages of holding Mutual Fund or ETF Shares in a Fund that offers both.

[14] For Funds adding an Exchange Privilege for one or more existing Mutual Fund Classes, the Adviser and the Board might also consider whether conversions of Mutual Fund Shares into ETF Shares may negatively affect economies of scale within the Mutual Fund Class. Because some 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 concerns might be allayed.

[15] Regulation Best Interest under the Exchange Act and the Financial Industry Regulatory Authority's 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 client, including relative to other Classes offered by the Fund.

[16] Note that expenses attributable only to a certain share class (or classes) could potentially be allocated only to the applicable share class(es).

[17] Note, however, that custody fees would generally need to be the same between an ETF Class and a Mutual Fund Class.

[18] 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.

[19] This may involve an assessment of the ability of intermediary platforms to handle processing such fees. We note that Vanguard's funds relying on their existing relief disclose the possibility of imposing such fees. In considering whether a purchase premium or redemption fee might be warranted, a Fund Board might look at 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 a proxy for trading costs with respect to the Fund's portfolio.

[20] *See* Section IV.A below on the potential challenges associated with on-going

monitoring of these costs on a class-by-class basis. 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.

[21] 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* Exchange-Traded Funds: Final Rule, Investment Company Act Release No. 33646 (Oct. 24, 2019).

[22] 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.

[23] Note that this comparison may be less appropriate where the assets in the ETF Class would not be sufficient to support a standalone ETF.

[24] *See* endnote 18 above describing scenarios under which having additional cash in the Fund may be helpful in connection with creation/redemption basket construction and portfolio rebalancing.

[25] More granular reporting could potentially include how much of any "cash drag" is estimated to be attributable to specific classes (*i.e.*, some classes may experience more frequent flows and the nature of these flows may necessitate larger cash holdings).

[26] An Adviser might consider how a credit facility might be used in lieu of larger cash holdings to meet redemptions and confirm that the costs of such a facility can be allocated to the appropriate classes.

[27] We note that a new bill introduced in the US House of Representatives (H.R. 2089, the "GROWTH Act") on March 11, 2025 would amend the Internal Revenue Code to allow individuals to defer recognition of reinvested capital gains distributions from Mutual Funds until investors redeem their shares. *See* https://www.congress.gov/bill/119th-congress/house-bill/2089/all-actions?s=1&r=1. While the fate of the bill is highly uncertain at this early stage, even if enacted, there would still be significant potential advantages of the Relief for Mutual Fund Class shareholders in a Fund operating with a combined class structure.

[28] While specific Board actions may not flow directly from the Board's review of this data, it should give the Board a view of how different types of shareholders are utilizing the share class options available.

[29] *See* endnote 3 above which notes that, for the sake of simplicity, this white paper 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, although this will not always be the case. ETFs are also able to externalize trading costs through the imposition of variable fees in connection with processing creations and redemptions. Most Mutual Funds do not use a similar mechanism, although short-term purchase premiums/redemption fees could be used for this purpose.

[30] We understand that GAAP requires brokerage costs to be included in the price of portfolio securities bought or sold by a Fund, which may complicate efforts to track these costs on a class-by-class basis (and, even where tracking is feasible, it may not be feasible to allocate these costs on a class-by-class basis).

[31] If the Adviser is able to engage in tax-loss harvesting when selling portfolio securities to generate cash to meet Mutual Fund Class redemptions, these benefits, if material, might be highlighted as offsetting, to some extent, related trading costs.

[32] Since ETFs do engage in portfolio trades in certain circumstances, board reporting on brokerage and trading costs should include data on both Mutual Fund and ETF Class transactions.

[33] That is, has the same Adviser, Board, investment objective(s) and fundamental investment policies. Note that it may not be possible to spin out a share class on a tax-free basis. 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 this flexibility, subject to applicable law.

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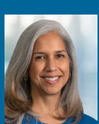
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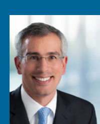
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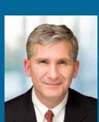
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