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ARTICLE

Mutual Fund to ETF Conversions – An Emerging Trend

An examination of the emerging trend of converting a mutual fund into an ETF and the necessary considerations and steps involved.

Introduction

According to an article[1] recently published in the Financial Times, "the age of the ETF is looming"[2] and recent indicators strongly support this position.

ETFs have grown consistently and significantly since their inception over 25 years ago. In fact, ETFs are now considered to be the fastest growing type of investment fund globally. Morningstar reports that global assets under management of passive, index-tracking ETFs hit a record $8.66tn at the end of June 2021 - an indication that ETFs may shortly become a dominant format for index investment globally.

From a European perspective, Ireland saw the launch of the first European ETF in 2000 and since then, Ireland has established itself as the largest European centre for ETFs and are now the domicile of choice for a broad range of managers. Typically established under the UCITS regime, ETFs benefit from the pan-European marketing passport and a widely recognised global brand.

There are many factors driving the increased global and European interest in ETFs: investors' increasing focus on fees and value for money; institutional demand for these products in their portfolio; growing scrutiny of the performance of active managers and the desire for greater liquidity and transparency are amongst the key drivers for this continued growth. In addition, despite the impact of the COVID-19 pandemic on global financial markets, ETFs have proven themselves resilient with assets under management levels showing strong recovery.

A recent IOSCO report[3] notes that the market volatility experienced during March and April 2020 was a significant stress test to the ETF structure and operation, and the report goes on to note that ETFs were found to be relatively resilient throughout the same period. An emerging trend in the United States is of managers converting existing mutual funds into ETFs. Managers including Guinness Atkinson, Starboard Investment Trust and Dimensional Fund Advisors have all converted mutual funds into active ETFs, with JP Morgan also recently announcing plans to convert four of its US mutual funds with $10 billion in assets into ETFs next year.

This trend is not unique to the United States. In December 2019, the Maples Group advised on the first European mutual fund conversion to an ETF with the establishment of the Credit Suisse Index

[1] https://www.ft.com/content/55ce5e82-55db-484b-ad6d-0b90b13970d9

[2] Robin Wigglesworth, Financial Times 16 August 2021

[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD682.pdf

Fund (IE) ETF ICAV. This conversion involved a cross-border merger of three existing Luxembourg domiciled index mutual funds into a newly established umbrella ETF authorised as an Irish UCITS ICAV. The conversion from a mutual fund into an ETF is a relatively novel concept, and one that we anticipate evolving over the coming years as growth and investor demand for ETFs continues.

Distinct from the general ETF growth factors set out above, other benefits driving the emerging ETF conversion trend include enabling the manager to use the mutual fund's previous performance record, therefore, any additional seed capital is not required. Managers can enter the ETF market with scale and a performance track record. Furthermore, managers are now seeing the ETF as an adaptable wrapper for a variety of investment strategies.

Key Considerations for a Conversion

Converting a mutual fund into an ETF raises important considerations from both an operational and legal perspective. Based on our experience, here is an overview into how these considerations need to be managed when converting a mutual fund into an ETF

From an **operational perspective**, managers need to give due consideration to the ETF ecosystem that is required to support trading of the ETF shares. A mutual fund conversion will require the introduction of certain new services providers into the structure to support the operation of the primary and secondary markets – including authorised participants ("APs"), market makers, listing agents and other ETF partners. This will involve developing or expanding on different relationships to those already in place in order to support the ETF structure. Managers also need to ensure that they will be able to support the calculation of the indicative NAV ("iNAV"), the delivery of the portfolio composition file ("PCF"), the use of in-kind trading and the creation and redemption process.

Distribution strategies will also need to be adapted for the ETF, owing to the interposition of APs into the ecosystem of the fund. Investor relations and marketing teams will need to be educated on the nuances of the ETF wrapper to ensure that they can market and promote the ETF appropriately and at the right level of the ecosystem in order to maximise their distribution efforts.

From a **legal perspective**, shareholder and board engagement is key. It is essential to bring shareholders into the discussions at an early stage in order that the necessary consents are secured. In essence, a mutual fund conversion into an ETF will result in a shift in the ownership arrangements for direct investors. For many shareholders, the conversion into an ETF (through a merger or change of structure) will change the manner in which their shares are held so it is important to engage with them, setting out in clear terms the overall impact of the change and providing shareholders with an opportunity to consider such a conversion.

Many mutual funds are unlisted. As such, by converting into an exchange-traded product, a new set of compliance obligations arising from exchange listing rules are introduced. This requires a co-ordinated effort to ensure that the relevant obligations are met and adopted as part of the fund's normal good governance procedures. Additionally, identifying the appropriate markets based on the existing and target investor base and determining which exchanges will best support trading is an important consideration for managers. Timing and coordination is also key for this part of the project.

Finally, the fund documentation will need to be updated to introduce appropriate language and required disclosures regarding the primary and secondary market trading and other key provisions specific to the ETF structure.

Conclusion

With the appropriate planning and resourcing, each of these operational and legal elements are manageable and should not act as a deterrent to any manager that may be considering a conversion of a mutual fund to an ETF. With lessons learned through the US and European experience, managers can now easily follow the footsteps of those first movers. The upsides in terms of potential asset growth, meeting investors' needs and demands and operating as a globally recognised product, with pan European passport capabilities will be the key drivers for such a conversion.

Furthermore with the Central Bank of Ireland indicating that it is willing to consider its position regarding active ETFs, the ability to convert mutual funds to ETFs will further appeal to active managers' goals of entering the fast-growing ETF space.

Authors

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