

A close-up, artistic photograph of several interlocking metal gears. The gears are rendered in shades of blue and white, with a bright, glowing light source positioned between two of the gears, creating a lens flare effect. The background is dark, making the metallic surfaces stand out.

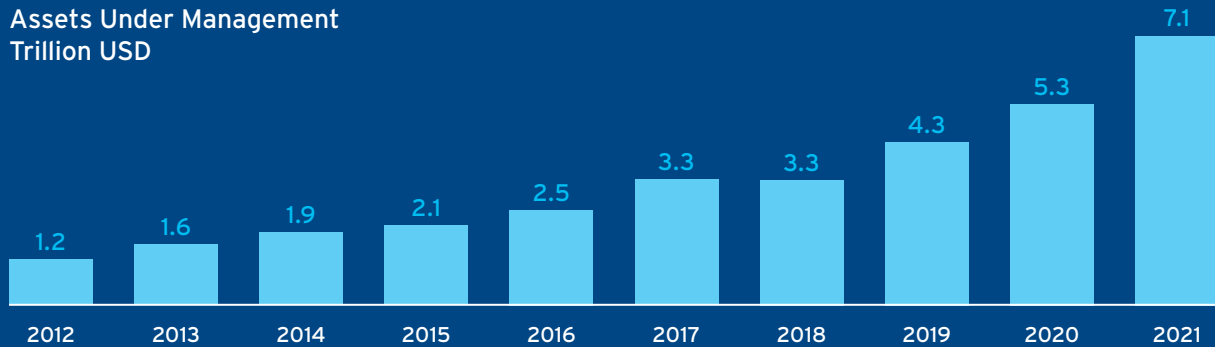
How to Convert a Mutual Fund to an ETF

Securities Services



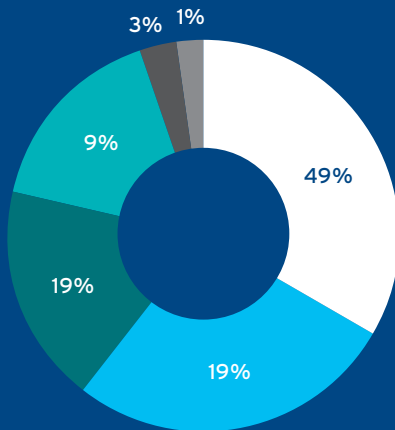
US ETF Market at a Glance

Assets Under Management
Trillion USD

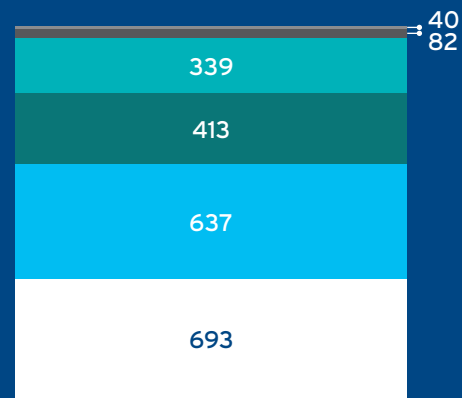


Source: ETFGI

Market Share by ETF Type



Number of ETFs by Type



Broad-Based Domestic Equity
 International Equity
 Bond
 Sector/Industry Domestic Equity
 Commodities
 Hybrid

Source: ICI (As of 31 December 2021)

So You Want to Convert a Mutual Fund to an ETF?

The US Exchange-Traded Fund (ETF) market has grown dramatically over the last decade, with an annual growth rate of over 19% and assets under management exceeding \$7 trillion at the end of 2021. In addition to the expected continued growth of the market, the approval of several semi-transparent ETF models has more active asset managers considering adding ETFs to their product offering.

A big challenge for managers entering the ETF market is building the scale necessary to be competitive. One way to achieve scale is to convert an existing mutual fund into an ETF, which can help firms get a leg up when entering the ETF race.

This guide highlights some of the considerations when converting a mutual fund to an ETF, along with the changes you may need to make to your operations.

What to Consider Before Making Your Mutual Fund an ETF

When contemplating converting a mutual fund to an ETF, there are some key things that need to be considered and actions that need to be taken before the conversion can occur. Thinking about these in advance can help to ensure a smoother conversion.



Does it **make sense** to convert your fund to an ETF?



Do you have the right **team and infrastructure** to run an ETF business?



Do you have the right **service providers** to support your ETFs?



What approach will you use to convert your fund?



What are the **changes** that you need to make to convert a fund?



What **approvals** will you need?

What Funds Should You Convert?

The first step in a conversion project is to identify which of your funds are good candidates to become ETFs.

A key variable is if you are seeking to launch a transparent or semi-transparent ETF. If the later, you will need to ensure your portfolio can comply with the regulatory restrictions. Currently, semi-transparent ETFs are limited to holding exchange-traded US securities.

You also need to consider how your funds are distributed and the shareholder base. For example, funds that are sold into 401(k) plans may not be good candidates because they risk losing investors in the conversion. Taking the time to assess the right candidate for conversion is critical for success.

Do You Have the Right Team?

You should be able to leverage most of your existing infrastructure to support ETFs. However, there are some elements that require specialized skills.

Organization



Capital Markets

A team of market specialists who interface with the broker-dealer and Authorized Participant community to assist in the creation/redemption process and can assist the sales team in technical client questions about execution and liquidity.



Product

A specialized ETF group responsible for the development, oversight, and ongoing management of the ETF product range.



Sales

The distribution of ETFs differs from mutual funds and most managers supplement their existing sales team with specialists who know the ETF landscape to maximize distribution opportunities and partner with chosen banks.

Operations



Portfolio Composition File (PCF)

The daily list of securities that is used to calculate the indicative NAV (iNAV), as well as in the creation/redemption process. Typically these files are provided by a service provider but firms need to incorporate these files into their workflows and processes.



Creation / Redemption Baskets

When ETFs create or redeem shares with the AP, a basket of securities usually changes hands. When creating the baskets, the manager makes decisions about what is included in the basket and then sends that data to the APs before the market opens.

What Services Providers Do You Need?

In order to launch an ETF, a number of service providers need to be appointed. Most are the same that are required for mutual funds but a few ETF-specific providers are required.

Traditional Service Providers

Administrator

Responsible for day-to-day operational support to the fund and provides NAV calculation, maintenance of books and records, PCF/AP order processing, and financial reporting services.

Custodian

Provides asset safekeeping, income collection, corporate-action processing, and oversight services.

Transfer Agency

Provides shareholder services to the fund, such as processing subscriptions and redemptions, and shareholder account opening and correspondence. For ETFs the Transfer Agent must be a member of the Depository Trust & Clearing Corporation.

Others

Includes legal advisors, auditors, tax advisors, and corporate secretary.

ETF Service Providers

Authorized Participant(s)

Liquidity provider(s) to the ETF that have exclusive rights to create or redeem ETF shares.

iNAV Calculation Agent

Responsible for calculating the intraday NAV of the ETF based on the underlying portfolio. Though no longer a requirement, many firms still prefer to produce an iNAV and semi-transparent ETF models may have their own unique intraday file requirements.

Market Maker

Broker-dealer or independent specialist that is contractually obligated to make two-way prices on the ETF throughout the trading day.

Listing Exchange

The venue where the ETF is listed and traded on the secondary market.

Which Conversion Approach is Best?

Once you have chosen which fund you wish to convert, you need to decide how to approach the conversion. This will define the scope of the project and impact all of your future decisions. There are two ways to approach a conversion.

Direct

The existing mutual fund is directly converted into an ETF with its governing documents and operations amended accordingly.

Indirect

A new ETF shell is established and the existing mutual fund is merged into the new ETF structure.



A Few Words about Tax

Anytime you reorganize a fund you should be cognizant of any potential tax implications. While there is nothing in an ETF conversion that would inherently cause negative consequences for the fund or investors, you should always seek guidance from a tax advisor to be sure.

What Changes are Necessary?

Regardless of the approach, the conversion to an ETF will necessitate some changes to your funds. At the heart of a conversion are the shareholders, so it's important that you have a well-articulated communication plan to engage with them throughout the process.

Share-class Consolidation

ETFs typically have only one share-class, so a mutual fund with multiple share-classes will need to consolidate into a single share-class. In the case of a **direct conversion**, you may need to adjust the fund documentation to update what the legacy share-classes will be consolidated into. For an **indirect conversion**, the terms of the merger agreement will detail how old shares are exchanged for new ones.

Fractional Shares

ETFs don't usually issue fractional shares and you will need a plan to deal with shareholders' fractional mutual fund shares. For a **direct conversion**, you will need to redeem the fractional shares before the conversion. In the case of an **indirect conversion**, you may need to redeem any fractional shares as part of the issuance of the new ETF shares.

Direct Shareholders

ETF shares are always held in a brokerage account and, unlike mutual funds, it's not possible for shareholders to directly invest. Consequently, you need to identify your direct shareholders and develop a program to deal with the issue of direct ownership. This can include partnering with a brokerage firm to create an easier mechanism to open accounts or a stock transfer agent to allow investors to continue to hold ETFs in registered form.

Documentation

Various changes to prospectus and registration filings are needed as part of the conversion process. For direct conversions in particular, existing fund documentation will need to be amended to reflect the change in fund structure.

Portfolio Changes

Depending on what type of ETF you are planning to launch, you may need to make changes to your portfolio. For example, a semi-transparent ETF can only invest in US exchange-traded securities. So, you may have to adjust your portfolio ahead of the conversion to ensure compliance with the relevant rules.



What Approvals are Needed?

To complete the conversion you need to secure a few approvals and work with your legal counsel to ensure that you have the necessary information in place.

Board Approval

Any conversion will require approval from the mutual fund board. When approving the conversion, the board needs to be comfortable that the switch to an ETF is in the best interest of the fund and that existing shareholders will not be negatively impacted. Given the differences between mutual funds and ETFs it may be necessary to have an educational program to help board members understand how ETFs work.

Shareholder Approval

Depending on the mutual fund's organizational documents and laws of the state in which it is registered, shareholder approval may be required. Furthermore, if doing an indirect conversion, listing rules may require the existing ETF shareholders to approve the merger with the mutual fund.

Regulator Approval

In order to execute the conversion you will need to obtain exemptive relief from the SEC. As more funds pursue a conversion, the process should become more straightforward.

How can we help?

Whether you're looking to establish an ETF or grow an existing platform, Citi can help. Across 13 domiciles, we offer a holistic enterprise-wide solution that can help coordinate through the entire ETF ecosystem, from issuance to fund servicing. Our consultative approach to ETF servicing, combined with ACES, our advanced workflow tool, provides a scalable platform with local expertise to support your ambitions.

Citi Securities Services supports the world's leading asset managers, institutional investors, and financial institutions. We provide a full suite of solutions in over 60 proprietary custody markets and 25 fund domiciles, including: custody, clearing, asset servicing, fund administration, ETF services, middle office, agency securities lending, collateral management, transfer agency, and fiduciary services. The combination of our global end-to-end service capabilities and Citi VelocitySM Clarity, our industry-leading data platform, enables our clients to futureproof and grow their business, while mitigating risks and reducing their infrastructure costs.

Let's Talk

To find out more about how our ETF Services can help you, contact your Citi Representative or email us at SecuritiesServices@citi.com.

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