ICI OPERATIONS

MAY 2020

Mutual Fund Share Class Conversions: A Matrix of Possibilities

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Contents

Introduction

Many asset managers distribute their mutual fund portfolios in a “multi-class” structure. Each class is distinguished by unique shareholder eligibility requirements, services offered, and combinations of fees and expenses for fund distribution. These options allow shareholders to select the best combination of features to meet their investment objectives. Fund documents such as prospectuses and statements of additional information (SAI) outline the available share class(es) for any given portfolio, disclosing applicable fees and expenses and describing shareholder eligibility and operating characteristics.[1]

Converting mutual fund shares from one share class to another within the same mutual fund portfolio is not a new concept; however, it is one that has garnered additional attention in recent years. Shareholders’ investing circumstances change over time, and what was once a suitable share class may no longer be the most appropriate for an investor because of changes in eligibility based on asset growth or other factors. For instance, investors may change how they receive and pay for investment advice, moving from a share class where commissions are paid on each transaction to an advisory program with different share classes where fees for advice are calculated based on assets under management.

Mutual fund share class conversions within the same mutual fund portfolio adjust the shares outstanding of the two affected share classes without altering the size of the mutual fund portfolio. The conversion transaction adjusts the shares held by accounts on the fund transfer agent system in each share class. When applicable, intermediaries must also post the share class conversion in beneficial owner accounts tracked by omnibus subaccounting or retirement plan participant recordkeeping systems.[2]

Conversions may occur at the initiation of the fund or an intermediary as the result of either a “coordinated” or a “non-coordinated” event corresponding to a business objective:

1. *Coordinated events* reflect a scheduled or planned activity at the fund or intermediary. Examples may include an intermediary’s scheduled conversion into a new share class structure or prospectus-driven periodic conversion from one share class subject to a contingent deferred sales charge (CDSC)[3] to a share class that is free from CDSC (e.g., Class B or C to Class A).
2. *Non-coordinated events* are often initiated by an intermediary’s financial adviser, are ad hoc in nature, or pertain to an individual or a small group of shareholders. Neither intermediary nor mutual fund operations groups typically receive advance notification that activity is to occur.

1 See Rule 18f-3 of the Investment Company Act of 1940 for general details and characteristics regarding multiple class funds.

2 In a subaccounting or retirement plan participant arrangement, the intermediary handles all communications and servicing of underlying shareholder accounts on its own recordkeeping systems (or that of its service provider) and reports share transactions to the funds on an aggregate basis. The fund’s transfer agent holds the aggregate (omnibus) account in the name of the intermediary. As a result, the underlying shareholders in an omnibus account do not directly interact with the fund organization.

3 A mutual fund fee imposed by some funds on shareholders who redeem (sell back to the fund) shares during the first few years of ownership. See “contingent deferred sales load” at www.ici.org/pdf/2020_factbook.pdf#page=317.

Operationally, the mutual fund industry has identified multiple approaches to complete share class conversions, also referred to as share class exchanges, for both coordinated and non-coordinated events. The approach used is often determined by the capabilities of the submitting organization's underlying recordkeeping system, the business objective, and common industry practices.[4] Parties will typically pursue the most automated transaction method available to them in hopes of recognizing maximum operational efficiency and risk-reduction benefits, although default/preferred approaches often differ between funds and intermediaries.

To assist those who may need to process mutual fund share class conversions, the Investment Company Institute's Broker-Dealer Advisory Committee (ICI BDAC) convened a task force of members—funds, intermediaries, and service providers—to consolidate the various broadly available automated approaches that are commonly used to complete mutual fund share class conversions. The task force's goal is to educate asset managers, intermediaries, and service providers about the options available and to highlight each option's benefits, risks, and barriers to adoption. The Share Class Conversion Matrix described in this paper is the result of the task force's work.

About the Share Class Conversion Matrix

The matrix on the following pages has been divided into two main sections, distinguished between coordinated and non-coordinated event types. Each event type is presented within the matrix one or more times, based on the alternatives available to process a share class conversion.

Considerations

- The ICI BDAC is committed to promoting operational efficiencies for all industry participants. For this reason, the task force limited the scope of automated trading processes and methods identified to those supported by DTCC Wealth Management Services, the industry's back-office trading, clearance, and settlement utility.[5] Manual processes are also noted for comparison purposes.
- The matrix intentionally excluded any *age-based* share class conversion events associated with 529 plan participants. These conversions, based on the age of the beneficiary or expected years prior to college enrollment, often involve modifications at the portfolio level. The 529 account follows its glide path toward expected college enrollment. Other 529 share class conversions follow the event types as depicted in the matrix for mutual funds.
- Mutual fund share class conversion eligibility and availability are governed by fund policies and procedures, documents (e.g., prospectus and SAI), and selling group agreements between trading counterparties. For these reasons, share class conversion should not be attempted until both parties agree upon and have confirmed eligibility.

The matrix presents summarized information. Details about information contained in the matrix are provided in subsequent pages.

4 An example of common industry practice documentation is the *Voluntary Share Class Conversions Best Practices* guide for users of the Fund/SERV® and Networking℠ services offered by the Depository Trust & Clearing Corporation (DTCC). Refer to the Wealth Management Services section of www.DTCC.com for additional product details and to www.dtcclearning.com to access the best practices guide.

5 Industry members may also pursue mutual fund share class conversions through proprietary system-based strategies.

Share Class Conversion Matrix

The matrix presents summarized information. Refer to the Share Class Conversion Matrix Details section for further definition and explanation of each column.

Coordinated Events

Event	Trading methods	Trading-specific criteria	Operational considerations *(Refer to Operational Considerations section for full details.)*
Class B to Class A roll	DTCC Fund/SERV DCC&S[6]	001 Order (sell) with Asset Type Indicator "G"	» Settlement risk exists. » Transaction transparency is available. » Eligibility by intermediary is a main consideration. **Event-specific considerations:** Transaction may be initiated by fund event—for direct-at-fund and non-omnibus intermediary accounts held on the transfer agent system. Transaction may be initiated by omnibus intermediary with agreement by fund and consistent with fund policies as outlined in the prospectus. Omnibus intermediaries may require a different roll date than the fund to consolidate the rolls across all fund families supported by the intermediary and to align with the capabilities of the subaccounting system.
Class C to Class A roll[7]	DTCC Fund/SERV DCC&S	001 Order (sell) with Asset Type Indicator "G"	» Settlement risk exists. » Transaction transparency is available. » Eligibility by intermediary is a main consideration. **Event-specific considerations:** Transaction may be initiated by fund event—for direct-at-fund and non-omnibus intermediary accounts held on the transfer agent system. Transaction may be initiated by omnibus intermediary with agreement by fund and consistent with fund policies as outlined in the prospectus. Omnibus intermediaries may require a different roll date than the fund to consolidate the rolls across all fund families supported by the intermediary and to align with the capabilities of the subaccounting system.
Firm program—bulk conversion	DTCC Fund/SERV DCC&S	001 Order (sell) with Asset Type Indicator "G"	» Settlement risk exists. » Transaction transparency is available. » Eligibility by intermediary for bulk conversion is a main consideration. **Event-specific considerations:** Transaction initiated by intermediaries; schedules may vary.

6 Refer to the Trading Methods and Criteria section of this paper for a description of DTCC Fund/SERV and the Defined Contribution Clearance and Settlement (DCC&S) solution from the National Securities Clearing Corporation (NSCC).

7 The ICI White Paper *C-Share (Level Load) Conversion: Operational Considerations* (www.ici.org/pdf/ppr_18_cshare_conversions.pdf) highlights a number of conditions that must be met before a new Class C conversion is implemented. These include the availability of share lots or other data that can confirm the age of shares held.

Coordinated Events

Event	Trading methods	Trading-specific criteria	Operational considerations *(Refer to Operational Considerations section for full details.)*
Firm program—bulk conversion	DTCC Fund/SERV sell/buy	001 Order	» Settlement risk exists. » Transaction transparency is more difficult than with Fund/SERV DCC&S since Asset Type Indicator is not permitted on the transaction. Sales and blue-sky reporting transparency are feasible through omnibus transparency reporting and may mitigate the effects of using a general 001 Order; however, the reduced transparency creates the added challenge of identifying the offsetting sell/buy transactions for portfolio management purposes. » Eligibility by intermediary for bulk conversion is a main consideration. **Event-specific considerations:** Transaction initiated by intermediaries; schedules may vary.
Firm program—bulk conversion	DTCC Fund/SERV exchange	015 Exchange with Transaction Type "C"' or Transaction Type "D"	**Generally, this is the fund's preferred method for share class conversions.** » Settlement risk is eliminated. » Transaction transparency is maximized. » Eligibility by intermediary for bulk conversion is a main consideration. » Exchange capabilities may vary by intermediary and could limit use. **Event-specific considerations:** Transaction initiated by intermediaries and directed to either existing (Transaction Type "D") or new (Transaction Type "C") account(s) with the fund transfer agent; schedules may vary.
Firm program—bulk conversion	DTCC Fund/SERV sell and DTCC Fund/SERV DCC&S buy	001 Order (sell) 001 Order (buy) with Asset Type Indicator "G"	**This transaction is not a best practice.** » Intermediaries are highly encouraged to use either Fund/SERV exchange or full DCC&S when submitting this type of share class conversion. » The 001 Order (sell) will cause the fund to unnecessarily raise cash to pay for the sell transaction without any way to relate the order to a share class conversion. » The DCC&S buy will indicate share class conversion, received the next morning, without a DCC&S sell order offset. This will require the portfolio manager to unnecessarily identify new securities to purchase while also adversely affecting transaction reconciliation.

Non-Coordinated Events

<table>
<tr><th>Event</th><th>Trading methods</th><th>Trading-specific criteria</th><th>Operational considerations
(Refer to Operational Considerations section for full details.)</th></tr>
<tr><td>Voluntary individual conversion</td><td>DTCC Fund/SERV DCC&S</td><td>001 Order (sell) with Asset Type Indicator “G”</td><td>» Settlement risk exists.
» Transaction transparency is feasible. Funds may request that voluntary (versus “bulk”) share class conversions are uniquely identifiable through omnibus transparency reporting.
» Eligibility by intermediary (and shareholder) is a main consideration.

Event-specific considerations:
Transaction initiated on an ad hoc basis by intermediaries.</td></tr>
<tr><td>Voluntary individual conversion</td><td>DTCC Fund/SERV sell/buy</td><td>001 Order</td><td>» Settlement risk exists.
» Transaction transparency is more difficult than with Fund/SERV DCC&S since Asset Type Indicator is not permitted on the transaction. Sales and blue-sky reporting transparency may be feasible through omnibus transparency reporting although, because the event is non-coordinated, it may be difficult for funds to monitor these transactions. The reduced transparency of the 001 Order creates the added challenge of identifying the offsetting sell/buy transactions for portfolio management purposes. Funds may request that voluntary (versus “bulk”) share class conversions are uniquely identifiable through omnibus transparency reporting.
» Eligibility by intermediary (and shareholder) is a main consideration.

Event-specific considerations:
Transaction initiated on an ad hoc basis by intermediaries.</td></tr>
<tr><td>Voluntary individual conversion</td><td>DTCC Fund/SERV exchange</td><td>015 Exchange with Transaction Type “C” or Transaction Type “D”</td><td>**Generally, this is the fund’s preferred method for share class conversions.**
» Settlement risk is eliminated.
» Transaction transparency is maximized. Funds may request that voluntary (versus “bulk”) share class conversions are uniquely identifiable through omnibus transparency reporting.
» Eligibility by intermediary (and shareholder) is a main consideration.
» Exchange capabilities may vary by intermediary and could limit use.

Event-specific considerations:
Transaction initiated by intermediaries on an ad hoc basis and directed to either existing (Transaction Type “D”) or new (Transaction Type “C”) account(s) with the fund transfer agent.</td></tr>
</table>

Non-Coordinated Events

Event	Trading methods	Trading-specific criteria	Operational considerations *(Refer to Operational Considerations section for full details.)*
Voluntary individual conversion	DTCC Fund/SERV sell and DTCC Fund/SERV DCC&S buy	001 Order (sell) 001 Order (buy) with Asset Type Indicator “G”	**This transaction is not a best practice.** » Intermediaries are highly encouraged to use either Fund/SERV exchange or full DCC&S when submitting this type of share class conversion. » The 001 Order (sell) will cause the fund to unnecessarily raise cash to pay for the sell transaction without any way to relate the order to a share class conversion. » The DCC&S buy will indicate share class conversion, received the next morning, without a DCC&S sell order offset. This will require the portfolio manager to unnecessarily identify new securities to purchase while also adversely affecting transaction reconciliation.
Voluntary “rep as PM”—multiple/bulk conversion	DTCC Fund/SERV sell/buy	001 Order	» Settlement risk exists. » Transaction transparency is more difficult to achieve than with other share class conversions since orders created for this purpose are often indistinguishable by the intermediary from regular sell/buy transactions. Assuming the intermediary back office can identify the transactions, sales and blue-sky reporting transparency is feasible through omnibus transparency reporting; however, the reduced transparency creates added challenge of identifying the offsetting sell/buy transactions for portfolio management purposes. Funds may request that these voluntary share class conversions are uniquely identifiable through omnibus transparency reporting. » Eligibility by intermediary (and shareholder) is a main consideration. **Event-specific considerations:** Transactions initiated on an ad hoc basis by an individual financial adviser. Generation of the transactions is not tied to intermediary programs or models that may initiate activity. Intermediary and mutual fund operations teams typically receive no notice of the transaction.

Non-Coordinated Events

Event	Trading methods	Trading-specific criteria	Operational considerations *(Refer to Operational Considerations section for full details.)*
Voluntary "rep as PM"—multiple/ bulk conversion	DTCC Fund/ SERV exchange	015 Exchange with Transaction Type "C"' or Transaction Type "D"	**Generally, this is the fund's preferred method for share class conversions.** » Settlement risk is eliminated. » Transaction transparency is maximized, as there would be intentional use of the share class exchange transaction, improving visibility to both the intermediary back office and fund. Funds may request that these voluntary share class conversions are uniquely identifiable through omnibus transparency reporting. » Eligibility by intermediary is a main consideration. » Exchange capabilities may vary by intermediary and could limit use. **Event-specific considerations:** Transactions initiated on an ad hoc basis by an individual financial adviser and directed to either existing (Transaction Type "D") or new (Transaction Type "C") account(s) with the fund transfer agent. Generation of the transactions is not tied to intermediary programs or models that may initiate activity.
Voluntary "rep as PM"—multiple/bulk conversion	DTCC Fund/ SERV sell and DTCC Fund/ SERV DCC&S buy	001 Order (sell) 001 Order (buy) with Asset Type Indicator "G"	**This transaction is not a best practice.** » Intermediaries are highly encouraged to use either Fund/SERV exchange or Fund/SERV sell/buy when submitting this type of share class conversion. » The 001 Order (sell) will cause the fund to unnecessarily raise cash to pay for the sell transaction without any way to relate the order to a share class conversion. » The DCC&S buy will indicate share class conversion, received the next morning, without a DCC&S sell order offset. This will require the portfolio manager to unnecessarily identify new securities to purchase while also adversely affecting transaction reconciliation. » Due to the nature of where and how these transactions originate (ad hoc, through the financial adviser/branch), the DCC&S buy option is most likely not available to the intermediary.

Non-Coordinated Events			
Event	**Trading methods**	**Trading-specific criteria**	**Operational considerations** *(Refer to Operational Considerations section for full details.)*
Involuntary individual conversion	Outside of DTCC	Manual activity through fund transfer agent	**Event-specific considerations:** Share class conversions completed by funds in response to intermediary resignation activity[8] will follow the fund's specific procedures. Transactions may be processed by exchange, with all inherent benefits thereof, or by sell/buy with appropriate identifiers to allow the fund to manage the transaction's blue-sky and tax reportability.
Manual individual conversion (voluntary or involuntary)	Outside of DTCC	Manual activity through fund transfer agent	**This transaction is not a best practice for intermediary-initiated transactions.** **Event-specific considerations:** » Share class conversions manually completed by funds in response to intermediary request should be considered exception processing. » Activity will be processed following the fund's specific procedures. Transactions may be processed by exchange, with all inherent benefits thereof, or by sell/buy with appropriate identifiers to allow the fund to manage the transaction as needed. Intermediaries will need to respond accordingly to the transaction processed by the fund, taking measures to ensure proper sales, blue-sky, and tax reporting. » Like all share class conversion activity involving an intermediary, funds that participate in NSCC Networking should generate an F55 Activity record with appropriate transaction type indicated.

8 Funds often have specific procedures that must be followed when an intermediary asks to remove itself as intermediary of record on an account serviced directly by the fund's transfer agent. There are additional operational and legal considerations with changes to custodial relationships on retirement accounts. Refer to the ICI white paper *Operational Process Flows and Considerations Related to Dealer/Custodial Resignations* (www.ici.org/pdf/ppr_19_operational_process.pdf) for additional details.

Share Class Conversion Matrix Details

Column Headings

1. *Event*: The coordinated or non-coordinated event that causes the need for share class conversion.
2. *Trading methods*: The first of two attributes that define how a share class conversion event is to be completed. For DTCC options, this method identifies the service and activity associated with the service. In some instances, more than one DTCC option exists to complete the event. For options outside of DTCC, it identifies the role of the fund's transfer agent in completing the event.
3. *Trading-specific criteria*: The second of two attributes that define how a share class conversion event is to be completed. For DTCC options, it provides key attributes of the trading method associated with the event.
4. *Operational considerations*: Lists the various operational and other factors that funds and intermediaries may consider evaluating related to the event. The evaluation may help with selecting the approach to completing a share class conversion event. Event-specific comments identify various positions or policies (e.g., stated in the fund's prospectus or operational policies) that funds and intermediaries may apply toward the event.

Events

The matrix is organized into sections; coordinated events are followed by non-coordinated events:

Coordinated Events

» *Class B to Class A roll*: A long-standing process governed by fund documents that converts eligible shares from a share class subject to a CDSC, once held for a specified duration, into a share class with a lesser 12b-1 fee[9] that is also free from CDSC. The name of this event is derived by the common industry reference of CDSC-eligible share classes as "Class B" and CDSC-free retail share classes as "Class A."

» *Class C to Class A roll*: A process governed by fund documents that converts eligible shares held in a level load[10] share class for a specified length of time into a share class with a lesser 12b-1 fee that is also free from CDSC. Rolls of this nature may apply to mutual fund and 529 plan accounts. There are certain Class C share classes that either do not support share class conversions or are in the process of implementing them.[11]

» *Firm program—bulk conversion*: Changes to contractual arrangements or assets under management for various investment programs (e.g., advisory programs, separately managed accounts, retirement plans) may lead to required changes in eligible share classes. Changes in retirement plan recordkeeping arrangements may also result in shifts to eligible share classes that would involve a sell from the resigning recordkeeper and a corresponding buy from the new recordkeeper.

[9] A mutual fund fee, named for the Securities and Exchange Commission (SEC) rule that permits it, used to pay distribution costs such as compensation to financial advisers for initial and ongoing assistance. See "12b-1 fee" at www.ici.org/pdf/2020_factbook.pdf#page=317.

[10] A combination of an annual 12b-1 fee (typically 1 percent) and a contingent deferred sales load fee (also often 1 percent) imposed by funds when shares are sold within the first year after purchase.

[11] Refer to the ICI white paper *C-Share (Level Load) Conversion: Operational Considerations* (www.ici.org/pdf/ppr_18_cshare_conversions.pdf) regarding the implementation of a new conversion.

Non-Coordinated Events

- *Voluntary individual conversion*: A share class conversion for an individual shareholder caused by shareholder or specific account activity. The most common examples include changes to the business arrangement used to receive and pay for investment advice, changes in total assets under management that affect share class eligibility, and the maturation of CDSC or level load shares into conversion eligibility.
- *Voluntary "representative as portfolio manager" (rep as PM) activity*: An individual financial representative (adviser) makes an investment decision that involves a share class conversion on behalf of the representatives' customers for which they have trading authorization. These are considered non-coordinated events because they are not part of a published, firm-wide investment program or model with advanced notification of the share class conversion activity to either intermediary or mutual fund operations teams. For many intermediaries, transactions are manually generated by the intermediary's branch office and often are indistinguishable from other transaction activity.
- *Involuntary individual conversion*: A share class conversion for an individual shareholder not caused by shareholder activity. For example, an intermediary's resignation from association with a shareholder's account may make the shareholder ineligible for the program and share class in which they are invested. Some funds are considering or have adopted policies related to resignations that may require share class conversion to achieve.
- *Manual individual conversion*: A share class conversion that is completed by the fund at the request of an intermediary but not through a coordinated event. Manual conversions requested by an intermediary of a fund can and should be avoided, when possible, by using an automated, straight-through processing trading method. Intermediaries should contact the fund to discuss any potential need for manual processing, and such requests should be sent only upon agreement that there is no other way to accomplish the conversion.

Trading Methods and Criteria

1. *Fund/SERV®*: The industry standard solution for mutual fund share trading, clearance, and settlement. Fund/SERV includes buy, sell, and exchange capabilities that may be used to facilitate share class conversions.
2. *Fund/SERV DCC&S*: The Defined Contribution Clearance & Settlement enhancement to Fund/SERV uses buy and sell orders sent by an intermediary and confirmed by the fund on the morning of trade date plus 1 day (T+1) during the DCC&S window. DTCC integrates all confirmed orders into daily net settlement obligations as if received on trade date (T). The expanded order delivery window allows intermediary systems time (on T) to apply the fund's trade date net asset value (NAV) to related activity and generate Fund/SERV 001 Orders overnight (on T+1). This sequence permits same-day adjustment to the shareholder's share balances in the old and new share class. Share class conversions should include Asset Type Indicator "G" on their DCC&S orders.

3. *Exchange*: One of two methods to facilitate a share class conversion through Fund/SERV (record type 015 Exchange). **In general, exchange is the preferred method for funds.** One exchange record includes both the sell and buy share classes and amounts. Share class conversions include Transaction Types “C” (for exchange into an existing account) and “D” (for exchange into a new account) on the Fund/SERV exchange record.

Enabling Use of Exchanges Through DCC&S

Exchanges may be sent through DCC&S, although they often make up a small portion of total DCC&S transactions submitted by intermediaries or received by funds. Exchanges will be included in net settlement activity from DTCC based on a combination of the rules comprising the CUSIP profile established at DTCC for the fund in question as well as the timing with which the fund’s transfer agent system confirms the transaction. Exchanges submitted through DCC&S either will settle “same-day” (today, as of yesterday) or “next-day” (tomorrow, as of yesterday). As a reminder, the debit and credit sides of an exchange offset, so there is no net impact to cash settlement requirements—regardless of the settlement date.

Funds set up their profiles at the DTCC to align with what is needed by their respective transfer agent systems. This includes how and when transactions post to their accounts and on related reports of fund activities. Funds are encouraged to communicate these expectations to intermediaries, if requested. Intermediaries may need to make additional adjustments if expected and actual transaction postings do not match.

4. *Sell/Buy*: One of two methods to facilitate a share class conversion through Fund/SERV (record type 001 Order). It is the most commonly available method among funds and intermediaries. All applicable shares are sold from the original share class, with proceeds used to buy the same value of shares in the new share class, using separate sell and buy orders. With successful execution on the same business day, the settlement obligations associated with the related orders offset.
5. *Outside of DTCC*: Used when a share class conversion requires additional administrative or legal approvals (e.g., exchange of documentation or information) or other requirements that cannot support the straight-through processing that automated solutions provide, or for fund-specific activities not involving an intermediary.

Operational Considerations

The share class conversion trading methods and criteria often create similar considerations, and potential risks, when each event is completed. The following highlights common operational considerations that may be experienced as part of each coordinated or non-coordinated event, depending on the trading method used.

1. *Settlement risk*: The inherent risks of using any of the sell/buy methods to facilitate a share class conversion is that they require cash settlement that is unnecessary and that could create unintended consequences:

   - *Order failure* occurs when one of the two orders does not reach settlement. While not common, failure of either order creates a less-than-optimal investor experience and can create market gain/loss on a conversion that should have zero monetary effect.
     - "Buy" failure **only** means that the fund must raise cash to remit "sell" order proceeds to the intermediary.
     - "Sell" failure **only** means that the intermediary must raise cash to settle the "buy" order.
   - *Transaction amount mismatch* occurs due to rounding differences (i.e., breakage) associated with each order.
     - Because two transactions are involved, there is always a risk of fractional share mismatch between the buy and sell sides of a transaction, due to rounding differences.
     - The time spent with reconciliation and subsequent "correction" to shareholder accounts is an unnecessary soft (i.e., personnel) cost of the breakage.
   - *Dividend accrual reconciliation* is sometimes problematic.
     - Accrual adjustments for Fund/SERV DCC&S transactions (which occur on T+1 as of T) are more likely to occur as accrual must be recalculated to tie to the previous trade date.
     - Accrual in the sell/buy method cannot be moved to the new account as dividend accrual; instead, it is often paid out in cash to the shareholder or used to acquire additional shares (as a separate transaction) in the receiving share class.
   - *Settlement timing differences* may exist between share classes, creating unintended consequences if sell and buy transactions are used. For example, institutional or advisory share classes often support a shorter settlement cycle than traditional retail share classes. If the "buy" attempts to settle before the "sell," similar issues to those described under *order failure* could apply.

2. *Transaction transparency*: Funds and their shareholders benefit greatly when they have transparency into the source and intent of all transactions, especially sell/buy orders.[12] Benefits fall into three main categories: portfolio management, sales reporting, and blue-sky reporting.

   » *Portfolio management* benefits from knowing when activity represents a share class conversion, because then the portfolio manager does not need to raise cash for a sell order or find suitable securities to invest cash for a buy order. This allows the portfolio manager to more consistently execute the investment objectives of the portfolio and avoid unnecessary transactions that raise trading costs for portfolio securities.

   » *Sales reporting* benefits by understanding the source of buy and sell activities. In this way, activity for the sales organizations of fund companies is accurately reflected and does not over- or understate what has occurred.

   » *Blue-sky reporting*[13] benefits from the clarity of distinguishing a share class conversion from other sell/buy activity. Depending on the state, the share class conversion transaction may be treated more favorably because the shares essentially offset, thereby saving the fund from paying associated blue-sky fees, a cost ultimately borne by shareholders.

In the case of omnibus transparency reporting on beneficial owner activity to funds (e.g., reporting provided by intermediaries through DTCC Omni/SERV[14]), it is important that all related share class conversion transactions are readily identifiable to ensure proper clarity and treatment for sales and blue-sky reporting. This could require use of unique transaction codes on the subaccounting or participant recordkeeping system for share class conversion transactions.

Funds that process through NSCC are encouraged to report all known share class conversion transactions on the DTCC Networking F55 Activity record as either a non–tax reportable share class exchange (Transaction Type 22) or a direct voluntary share class exchange (Transaction Type 35), where intermediaries must assign tax reportability to follow the fund's policies for the share class exchange processed. This would apply to any manually processed transactions by the fund's transfer agent as well.[15]

[12] Use of Fund/SERV exchange transactions resolves many of these challenges. Proper use of Fund/SERV DCC&S Asset Type Indicator "G" assists with share class conversion identification.

[13] Most states require some form of registration of mutual fund shares and the tracking of sales activity and may also collect activity-based fees. Collectively, the laws governing these practices are called *blue-sky laws*.

[14] Omni/SERV provides a centralized platform for intermediaries to deliver beneficial owner account activity and position reporting to funds. Refer to www.dtcc.com/wealth-management-services/mutual-fund-services/omni-serv for additional details.

[15] Refer to the *Voluntary Share Class Conversions Best Practices* guide found at www.dtcclearning.com.

3. *Eligibility by intermediary*: Share class eligibility and conversion, where applicable, are addressed by the policies and procedures identified in fund documents, such as the prospectus and SAI. Intermediaries must honor and apply fund policies not only to the intermediary's accounts held on the fund's transfer agent system but also to any beneficial owners in an omnibus (e.g., subaccounting or retirement plan participant) arrangement with the intermediary.

   More recently, the Securities and Exchange Commission (SEC) published guidance that permitted intermediary-specific variations in sales loads and eligibility.[16] When mutually agreed to by the fund's board and requesting intermediary, these instructions supersede the standard prospectus language for the related class of shareholders and may be disclosed as such within the prospectus or permissible prospectus appendix. The result may be share class conversions occurring with different frequencies or even between different share classes, based on the intermediary involved.

   The contractual arrangements between funds and intermediaries and/or prospectus disclosure often define the parameters of intermediary-specific variations in sales loads and eligibility, as well as the eligible share classes for intermediaries to use. All parties should familiarize themselves with these capabilities before pursuing any share class conversion activities.

4. *Exchange capabilities*: As previously stated, one exchange transaction includes both the sell and buy sides of the share class exchange. This has numerous advantages for transaction reconciliation, accrual movement and reconciliation between accounts, and the elimination of settlement risk.

   » *Transaction reconciliation* becomes simpler because both sides of the share class exchange are part of the same physical order/transaction record. It is very easy to confirm successful execution of both sides of the share class exchange.

   » *Accrual movement and reconciliation* is typically more direct and simplified with an exchange. Where applicable, dividend accrual amounts typically move directly between fund transfer agent accounts. This is opposed to sell/buy transactions that are created to move accrual between one to three days after the exchange. Those transactions must be (1) identified as a trailing dividend that moves accrual, and (2) correctly coded to handle tax and cost basis reporting in both share classes.

   » *Settlement risk* is avoided with exchange transactions because both the buy and sell sides of the share class conversion will either process or fail together.

[16] See *Guidance Update 2016-06: Mutual Fund Fee Structures*, published in December 2016 by the SEC's Division of Investment Management, at www.sec.gov/investment/im-guidance-2016-06.pdf.

Fund transfer agent systems are equipped to process exchange transactions. A successful execution of the exchange method requires funds to enable transfer agent system rules to permit shares to move between the related share classes as an exchange transaction.

Intermediaries using exchange capabilities through DTCC must indicate their share class exchange is to a new (Transaction Type "C") or existing (Transaction Type "D") account. However, many intermediary systems only support sell/buy activity, and those supporting exchange transactions may not fully address the share class conversion's nontaxable nature and its corresponding effects on tax and cost basis reporting. Omnibus intermediaries should consider how differing accrual methodologies between omnibus and participant subaccounts (regular or retirement plan) may affect account balances and accrual reconciliation activities.

5. *Other considerations*: Depending on the share classes involved, the following items may pertain to or be affected by a share class conversion:

   » *Short-term trading policies*, most notably redemption fees, may need to be considered when a share class conversion is processed. Intermediaries should understand the fund's redemption fee policies—including any potential waivers due to the facts and circumstances related to the share class conversion—prior to initiating the conversion transaction. Omnibus intermediaries will need to assess any applicable fees at the subaccount level on the debit side of the transaction unless alternate arrangements have been made with the fund.

   » *CDSC eligibility* can affect share class conversions out of traditional Class B and Class C (level load) share classes. Fund policies, as outlined in the prospectus and other fund documents, will guide applicability. Alternatives may include leaving shares in the original share class to age beyond CDSC applicability, paying any CDSC prior to or in conjunction with the share class conversion transaction, or treating the share class conversion as qualified for a CDSC waiver or as shares that are free of CDSC liability. Omnibus broker-dealers will need to apply the fund's policies at the subaccount level unless alternate arrangements have been made with the fund.

   » *Rule 12b-1 payment accrual* is most notably affected when there are timing differences between buy and sell transactions. Omnibus intermediaries must consider these effects on subaccount balances that may, in turn, directly affect financial adviser compensation. The potential discrepancy underscores the need to understand and, where possible, mitigate differences before a share class exchange is processed—to avoid reconciliation issues and subsequent corrective activity.