

ICI OPERATIONS

SEPTEMBER 2024

# Mutual Fund to ETF Conversion: Operational Considerations

Mutual Fund to ETF Conversion Task Force

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# Mutual Fund to ETF Conversion: Operational Considerations

## Introduction

Beginning in 2021, there has been a steadily increasing trend of mutual funds converting to ETFs. Some key differentiators between mutual funds and ETFs are how investors purchase and sell shares, and how the funds themselves purchase and sell portfolio holdings. ETFs are attractive to certain investors, when compared to mutual funds, because they offer intra-day liquidity and provide increased transparency on holdings information, often with lower fees. Certain ETFs can also provide greater tax efficiency to investors in taxable accounts. When compared to mutual funds, these potential benefits have led to increasing interest in the use of ETFs as an investment vehicle.

Some asset managers have observed this increased customer interest in ETFs and have looked for opportunities to either launch new ETFs or convert an existing mutual fund offering to an ETF, thus allowing asset managers to enhance their ability to compete in the ETF marketplace. The decision to convert a mutual fund to an ETF is driven by many considerations, including a fund's distribution model, complexity, and the composition of its shareholder base.

Converting a mutual fund to an ETF is a highly bespoke process. There are disparate systems used by mutual funds and ETFs for trading, clearance, settlement, and shareholder recordkeeping that must be coordinated to wind down (mutual fund) and start up (ETF). To receive ETF shares, mutual fund shareholders must already have, or need to establish, a brokerage arrangement prior to conversion, including all mutual fund shareholders that are directly serviced by the asset manager. A conversion by merger may also require collapsing multiple mutual fund share classes into one ETF, involving different conversion factors for each share class. Often, there are trading moratoriums in the days leading up to the conversion that must be coordinated and may require manual implementation. In all instances, there are few standardized processes or straight-through processing capabilities to support the conversion process across asset managers.

In response to this challenge, the Investment Company Institute (ICI) created the Mutual Fund to ETF Conversion Task Force, which comprises asset managers, intermediaries, service providers, and the Depository Trust and Clearing Corporation (DTCC), to identify the considerations relevant to planning and executing these complex transactions. Participants represent organizations serving on a variety of ICI committees involved with conversion activities. They work in the following functional areas:

- » Mutual Fund Transfer Agency Operations
  - » Account set up/maintenance
  - » Share trading/settlement
- » ETF Secondary Market Operations
  - » Shareholder position set up/maintenance
  - » Share trading
- » Mutual Fund/ETF fund accounting
- » Mutual Fund/ETF fund administration
- » Mutual Fund/ETF portfolio management
- » Mutual Fund/ETF product management
- » Mutual Fund/ETF legal
- » Mutual Fund/ETF intermediary relationship management
- » Mutual Fund/ETF conversion project managers
- » ETF authorized participants (APs)
- » ETF market makers

The considerations document and checklist that follow are a result of numerous discussion sessions and interviews with various stakeholders who are planning or have already completed one or more conversions. Each mutual fund to ETF conversion event is unique and can vary depending on the circumstances that an asset manager must independently consider while serving the interests of shareholders. These materials are designed to assist asset managers, intermediaries, and service providers in planning and implementing conversion activities. Furthermore, these materials may prove useful in encouraging the adoption of practices that reflect thoughtful, proactive communication, application of technology, and comprehensive planning for a successful conversion event.

# Background

## Mutual Fund to ETF Conversion Types

**Merger/Shell Reorganization:** In this scenario, the existing mutual fund is merged with a newly created shell ETF, often under a new trust.

**Direct Conversion:** In a direct conversion scenario, the existing mutual fund vehicle is converted into an ETF with appropriate modifications to constituent documents and operations.

## Initial Decisions

If the mutual fund offers multiple share classes, these may need to be consolidated into a single share class prior to, or at the time of, the conversion as ETFs do not currently offer multiple classes.

Once the decision is made to convert or merge the mutual fund into an ETF, determinations may need to be made about a variety of mutual fund fees and expenses, including Rule 12b-1 fees, contingent deferred sales charges (CDSC), upfront sales charges, and letter of intent (LOI) obligations.

The asset manager must also work with a listing Exchange to ensure that the ETF will be appropriately listed in compliance with the Exchange's requirements.

In all instances, it is important to consider the amount of time needed to accomplish the various operational steps detailed in this outline and recognize the inherent dependencies on filings approvals, notification periods to shareholders, and the coordination of mutual fund and ETF Board meetings.

## Associated Costs

The asset manager should consider the following expenses, among others, which may arise in performing a conversion and evaluate the business implications (and note that Rule 12b-1 and sub-transfer agency fees are not typically charged by an ETF):

- » Legal fees
- » Audit fees
- » Listing fees
- » Print/mail fees
- » Proxy expenses
- » Marketing expenses
- » Operational expenses (e.g., corrections post-conversion)
- » Conversion fees that counterparties may assess
- » Service provider fees (e.g., mutual fund transfer agency fees and potential stock transfer agency fees)
- » Identifying and hiring a stock transfer agent
- » Training and education of sales and distribution channels
- » Time commitment for operational staff and project teams

## Operational Considerations for Asset Managers

Asset managers can consider the following points (not necessarily in sequential order) when planning for and executing a mutual fund to ETF conversion:

- 1. Identify and engage internal groups that will help effect the conversion as well as support its execution.** This may include the Product, Portfolio Management, Capital Markets, Legal, Compliance, Risk, Marketing, Fund Operations and Accounting, Customer Service, Relationship Management, and Sales teams.
- 2. Identify impacted shareholder populations.** Asset managers should educate themselves about the underlying account make-up in the mutual fund targeted for conversion (for instance, the number and types of accounts holding the mutual fund and the percentage of assets they each represent).

In cases where the mutual fund is offered in retirement plans via a plan administrator, it may not be an ideal candidate for conversion given the amount of shareholder communication and account transition work entailed. Often, a retirement plan may not be able to hold ETFs if they are not approved investment vehicles for the plan. Shares in the converting mutual fund that are not exchanged to something else prior to converting to an ETF may be forced to sell, resulting in tax implications of a premature distribution for redeeming shareholders.

In addition to retirement plan considerations, a fund that is part of any proprietary model portfolio is another that might not be a suitable candidate. Many mutual funds are also offered in automated, recurring purchase programs or in automated rebalancing models with advisors. These transactions would need to be identified and adjusted or turned off prior to conversion. At minimum, the asset manager must provide advance notice to investors and offer operational assistance to process redemptions. Conversely, the investor must either establish a new brokerage account or use an existing one to hold the ETF shares.

- 3. Determine treatment of fund direct accounts.** Arrange for mutual fund shareholders that are holding fund shares directly with the fund's transfer agent to open a brokerage account with a brokerage firm to hold and transact in the new ETF. (If a fund shareholder does not have a brokerage account, the asset manager may decide that new ETF shares may be held by a stock transfer agent until a brokerage account is available.) Direct accounts are otherwise handled in one of two ways, prior to the conversion date: shares of the converting fund must be exchanged into another fund offered by the asset manager, or shares must be redeemed (i.e., liquidation and delivery of proceeds/account is converted to cash). Asset managers will need to ensure proactive communication and clearly defined servicing steps to assist those mutual fund shareholders whose fund is being converted. For direct accounts not in omnibus and at the beneficial owner level, the asset manager should be prepared to provide share and cash allocation information to intermediaries. Asset managers need to also consider any escheated accounts with a position in the converting mutual fund and confirm their procedures for proper handling.
- 4. Work with the Board of Directors/Trustees and obtain any necessary approvals.** Provide information to the Board to educate them about ETFs and help them understand the reasons why the conversion is expected to be beneficial to shareholders. Engage early and often with fund and Board counsel to understand the necessary Board approvals.

The asset manager should be prepared to demonstrate product and operations knowledge in the differences between mutual funds and ETFs and evidence appropriate updates to policies and procedures. The asset manager should also be prepared to provide the Board with information about any potential conflicts of interest in offering a mutual fund and ETF in the event the asset manager continues to provide both.

5. **Determine whether shareholder approval is needed.** Work with legal counsel to determine whether the conversion will require the approval of the mutual fund's shareholders. If so, obtain shareholder approval via the proxy process. Members of the task force note that the shell/reorganization model for conversion is more commonly used in part to minimize the need for proxy approval.
6. **Create and file necessary regulatory documents and shareholder notices.** Identify and file any necessary prospectus supplements, information statements, or other documentation required to advise investors of the conversion, important dates related to the conversion, and necessary actions regarding their mutual fund holdings. Updated regulatory documents may reflect changed parameters around the fund offering, and any updates to 12b-1, CDSC, or other fees in preparation for conversion.
7. **Consider if share class consolidation is necessary.** In the case that the converting mutual fund has multiple share classes, the asset manager may need to consolidate (merge) the share classes offered prior to any conversion. This consolidation will require additional notification lead time, communications, and legal and operational work. The asset manager should consider which share class should be the "destination" class for all the mergers, keeping in mind shareholder eligibility for the exchange and intermediary access to that share class.

The potential for future state, multi-class ETFs could be a factor in the decision to consolidate share classes. At present, consolidating share classes of the mutual fund on the transfer agent side prior to the ETF conversion step may lend operational efficiencies but may not be possible; a merger may be necessary concurrent with and as part of the ETF conversion event.

8. **Arrange for the redemption of fractional shares.** Fractional shares of the mutual fund may need to be redeemed at Net Asset Value (NAV) and issued as a cash payment to the mutual fund shareholder, as ETFs do not issue fractional amounts. Asset managers should establish the timing of when they will process fractional share liquidation (i.e., pre-conversion or on the conversion date) and include this information in communications with shareholders, service providers, and intermediaries. It may be feasible to liquidate fractional shares on the last day of trading for the mutual fund. Redemption would be at NAV and a cash payment would be issued to the shareholder, which helps avoid moving cash on the conversion date.

In the case of omnibus accounts, many of the providers perform a sale of fractional shares after the conversion. Notably, liquidating fractional shares could result in a large volume of small cash payments to be processed and distributed. Pre-communication of this route to allow for the transfer agent, intermediaries, and operational servicing teams to prepare payment instructions could reduce errors and delays. For intermediaries, cash delivery can result in lump sum checks that do not have the necessary information on shareholder account allocations. (The same may be true of consolidated wire payments to omnibus accounts.)

**9. Develop shareholder communications.** Prepare and provide Client Service, Sales, and Research teams with a script and talking points to help facilitate customer interactions and address their questions. Financial advisors and intermediaries should also receive this information to drive awareness and assist in communicating to their clients. Asset managers should consider the number of days needed for communication preparations and legal and compliance review and build this into their timeline. Asset managers should take care to articulate the different qualities of ETFs to their mutual fund clients whose fund is undergoing conversion. Providing plain English disclosure on the firm website(s), a press release, and messaging on quarterly account statements can assist with this process. Depending on accountholder registration type or distribution structure, task force members report that a 90-day advance notice is typically the minimum. Asset managers may also want to coordinate with and assist intermediaries in drafting appropriate messaging to beneficial owners.

## Conversion Processing Considerations: Activities with Industry Partners

**10. Engage with third party service providers, distributors, and intermediaries.** The asset manager should identify and communicate the planned conversion with key third party service providers, such as the transfer agent, fund administrator, custodian, statutory distributor, stock transfer agent, receiving platform and group on the ETF side, regulatory mailing provider, proxy agent, and securities lending agents. Depending on the distribution network, outreach to broker/dealers, turnkey asset management programs (TAMPS), banks, financial advisory programs, and the full chain of intermediaries is key. Other critical parties include the DTCC, Depository Trust Company (DTC), National Securities Clearing Corporation (NSCC), the listing Exchange for the ETF, and reporting/data agencies.

It may be helpful to organize an initial announcement, follow-up reminders, and one or more pre-conversion date meetings or conference calls with these entities to ensure readiness. Having a playbook that includes contact names and details for key parties involved in processing and other operational activities can assist with escalations and resolving any issues at conversion time and the window immediately afterwards. Also involve independent auditors, as their services may be needed regarding the seeding of the ETF.

**11. Consider the timing of the conversion.** Asset managers will need to identify a closing date for the mutual fund for the conversion to take place. It may be beneficial to avoid dividend dates, holidays, month- and year-ends, other known industry events, or other fund complexes' conversion dates given the drawdown on resources at service providers, intermediaries, and within asset manager's own personnel. Asset managers should talk to their intermediary partners, service providers, and DTCC to find out what activities might be happening at the same time as the (proposed, actual) conversion closing date.

**12. Identify intermediary special considerations.** Some intermediaries may consider the ETF a new product, requiring their new product approval process. Asset managers should look to confirm if this requirement is present, as its conditions and any purchase restrictions might preclude offering the new ETF on the intermediary's platform. A mutual fund share class merger in preparation for the ETF conversion may also fall into this category. Clearing arrangements may change if intermediaries holding the mutual fund cannot clear ETFs.

Asset managers should have planning conversations with omnibus firms to understand their conversion strategy. Some may need to move to non-omnibus accounts prior to the conversion or may need to move to a different entity (i.e., different NSCC IDs). It is important to understand how and when intermediaries will process fractional shares. Some may have a hybrid model within their omnibus account requiring more support by the firm or may not be able to hold ETFs (due to agreement terms, the retirement plan, etc.).

On the intermediary's part, from a middle and back-office perspective, information about the conversion likely needs to cross multiple teams, systems, and platforms that are not typically integrated and require manual processing. Ensuring awareness of the conversion and delineating ownership of responsibilities to teams such as mutual funds, equity trading, settlements, dividends, corporate actions, account transfers, and treasury may help reduce issues with rejects, blocks, suspense items, and the like.

**13. Consider the transfer agent's responsibilities.** The converting mutual fund's transfer agent has additional responsibilities in the process, beginning with ensuring that their existing systems can support how an asset manager intends to execute the conversion. The parties should also consider and agree on how to resolve post-conversion adjustments or corrections, noting that once the mutual fund is converted, share reprocessing is not an option. The ETF will need to have an entity to keep track of its shares, too. Typically, the mutual fund transfer agent does not perform these services so the asset manager may need to hire a new entity to perform this service.

**14. Ensure the tasks below are completed leading up to conversion weekend:**

- » Evaluate timelines to handle transfers (i.e., re-registration of shares) via various means (e.g., Automated Customer Account Transfer Service (ACATS), NSCC Networking, Manual), and set deadlines accordingly.
- » Process final redemptions for retirement recordkeepers, trust companies, or others that cannot hold/will not support ETFs.
- » Trading moratorium/restrictions: Block trading of the converting mutual fund and close its CUSIP. Identify last days for purchases, exchanges, redemptions, NSCC Fund/SERV, and Defined Contribution Clearance & Settlement (DCC&S) trading.
- » For daily accrual funds, distribute income (at the single day daily rate).
- » Ensure the ETF Listing will be declared by the Exchange.

## 15. Follow the conversion weekend tasks:

- » Transfer underlying securities positions.
- » The task force offers as a recommended practice for asset managers to complete and submit the MF-to-ETF conversion template through DTCC MF Info Xchange.<sup>1</sup> Firms should leverage the current fund merger template with ETF details until a conversion template is released. (Expected in a future enhancement).
- » Provide a 4-digit NAV. If the fund does not normally strike a 4-digit NAV, it is recommended that the asset manager inform parties that are not part of the conversion of such measure.
- » Supply any conversion ratio, if needed. A conversion ratio is needed if the mutual fund shares are not converting on a one-to-one basis into the ETF. This is often the case when multiple mutual fund share classes are converting into the same ETF.
- » Complete final sharelot reconciliation with NSCC.
- » Transmit DTC delivery instructions for ETF shares.
- » Prepare for wiring of fractional share proceeds.

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<sup>1</sup> DTCC's MF Info Xchange facilitates and centralizes the delivery and receipt of time-critical mutual fund, bank collective fund and other pooled investment product notifications to reduce risk throughout the communication process. See [www.dtcc.com/wealth-management-services/mutual-fund-services/mf-info-xchange](http://www.dtcc.com/wealth-management-services/mutual-fund-services/mf-info-xchange) for additional details.

## APPENDIX

# Mutual Fund to ETF Conversion Preparation Checklist

The checklist reflects some of the preparatory steps asset managers may consider in the performance of Mutual Fund to ETF conversions. It is not to be interpreted as a complete, step-by-step manual for performing this activity but serves as a basis for asset managers to begin outlining a project plan. It should be further supplemented with internal information on their firm's conversion specifics and requirements as agreed with their service providers and distribution network.

The checklist is organized around dates occurring before, during, and after the Mutual Fund to ETF conversion. Each conversion step listed is cross-referenced to either the Background section or any number of the 15 Operational Considerations for Asset Managers highlighted in the white paper.

Note: Timelines on reaching contractual agreement with a service provider may vary and asset managers may need to build in more time than is reflected in the scenarios identified in the Considerations Summary.

Timeline Conversion Date (“CD”)	Conversion Step	Reference Consideration Item(s) #
<b>CD 120+</b>	<p>Identify mutual funds that may be conversion candidates.</p> <p>Conduct cost analysis on conversion.</p> <p>Identify internal project team and engage business groups that will play a role in the conversion activities.</p> <p>Identify and conduct analysis on the make-up of the shareholder universe comprising the converting fund.</p> <p>Prepare plan for Board presentation and seek approval for mutual fund conversion. Obtain Board Approval/Votes.</p> <p>Outline and draft communication materials for Legal &amp; Compliance approval.</p> <p>File prospectus updates, registration statements, and proxy (if needed). Obtain shareholder approvals as needed.</p> <p>If not already in an existing agreement, identify and contract with Authorized Participants (APs) for the ETF.</p>	<p>Asset Manager Internal Decision/Analysis *Note, if the Asset Manager is going to create a new shell fund, then more than 120 days may be needed, as there is typically a 75-day review period for most new funds.</p> <p>Asset Manager Internal Decision/Analysis</p> <p>Considerations Point 1</p> <p>Considerations Points 2, 3</p> <p>Asset Manager Internal Decision Considerations Point 4</p> <p>Considerations Point 6</p> <p>Considerations Points 5, 6</p> <p>Asset Manager Internal Decision</p>
<b>CD -90 to -60</b>	<p>Socialize conversion plan with third party service providers (e.g., transfer agent, regulatory mailing agents, and intermediaries). Provide talking points and agree on playbooks for the event.</p> <p>Issue and post communications to impacted shareholders, financial advisors, retirement plans, etc. Make public announcement.</p> <p>If needed, identify and contract with stock transfer agent.</p> <p>Work through ETF product approval process with intermediaries.</p>	<p>Considerations Points 10, 11, 13</p> <p>Considerations Point 9</p> <p>Asset Manager Internal Decision</p> <p>Considerations Point 12</p>

Timeline Conversion Date ("CD")	Conversion Step	Reference Consideration Item(s) #
<b>CD -60 to -45</b>	<p>Perform consolidation/mergers of mutual fund share classes to a surviving share class if applicable and part of overall plan to convert remaining share class to an ETF.</p> <p>Ready plan for fractional share treatment and processing. Work with distribution and intermediary channel to prep for cash distributions if needed.</p> <p>Work with intermediary to ready an error account for use in balancing the differences if a conversion ratio is used.</p> <p>Send reminders to shareholders to arrange for brokerage accounts to hold the ETF.</p> <p>Ensure blackout periods are communicated to all intermediaries.</p>	<p>Considerations Point 7 Asset Manager Internal Decision</p> <p>Work with transfer agent and service providers as needed to implement soft and then hard closures of share classes leading up to their merger date(s).</p> <p>Considerations Point 8</p> <p>Considerations Point 8</p> <p>Considerations Points 3, 9</p> <p>Considerations Points 10, 14</p>
<b>CD -7 to -1</b>	<p>Ready and implement operational measures for trade and transfer (ACATS) restrictions. Hard close the mutual fund.</p> <p>Distribute income on the mutual fund.</p> <p>Ready wire instructions for payment of residual cash from fractional shares.</p> <p>Ensure ETF Listing will be declared by the Exchange.</p>	<p>Considerations Points 14, 15</p>
<b>Conversion Weekend</b>	<p>Use expanded 4-digit NAV (and conversion ratio(s), if needed).</p> <p>Mutual fund shares are liquidated, and proceeds converted to ETF shares based on pre-determined ratio.</p> <p>Final sharelot reconciliation with DTCC.</p>	<p>Considerations Point 15</p>
<b>Post-Conversion CD+</b>	<p>ETF live on Exchange.</p> <p>ETF position live in investor brokerage accounts.</p>	



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