Proskauer

Quant Firm Applies to Issue ETF Share Classes in Mutual Funds

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Dimensional Fund Advisors LP ("Dimensional"), a quantitative investment firm, recently filed an application for exemptive relief ("Application") with the Securities and Exchange Commission ("SEC"),[1] seeking permission to offer exchange-traded funds ("ETFs") as a share class of Dimensional's existing actively managed mutual funds. If granted, the exemptive relief would enable Dimensional to leverage the tax efficiency and lower portfolio transaction costs of the ETF wrapper for many of its established products. The Vanguard Group, Inc. ("Vanguard") was the first investment firm to introduce this fund structure more than two decades ago[2] and obtained a patent for it, which meant that other firms have historically needed to seek a license from Vanguard to adopt a similar approach. However, the patent expired in May 2023.[3]

Background

Since its adoption in 2019, Rule 6c-11 (the "ETF Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), has sought to provide a consistent and transparent regulatory framework for ETFs by setting forth standardized conditions for such ETFs to operate without needing to obtain individual exemptive relief from certain sections of the 1940 Act. While the ETF Rule applies broadly to both passively managed and actively managed ETFs, the rule does not apply to certain particular categories of ETFs, including, among others, ETFs structured as share classes of a multi-class fund.[4] ETFs which are not eligible to rely on the ETF Rule must instead seek exemptive relief from the SEC to engage in activities and transactions that are otherwise prohibited under the 1940 Act, such as effecting sales of ETF shares at market price rather than net asset value (NAV) or allowing investors who hold more than 5% of the ETF to redeem their ETF shares in kind.

In December 2000, Vanguard became the first, and to date only, ETF sponsor to obtain exemptive relief in order to offer a class of ETF shares within an existing open-end, passively managed registered investment company, which structure Vanguard quickly patented.[5] In an effort to mitigate SEC concerns regarding potential investor confusion and certain unique conflicts of interest that differed from those traditionally present in non-ETF multi-class share structures, Vanguard agreed, among other conditions, to take certain measures to help shareholders to understand the differences between the ETF shares and non-ETF shares of a given fund and to track certain data relating to shareholders who elected to convert their non-ETF shares into ETF shares of the same fund. Notably, the exemptive relief granted to Vanguard covered only its index funds, and when Vanguard requested that this relief be extended to cover its actively managed ETF in 2015, the SEC declined.[6] Vanguard's patent on the above ETF share class structure expired in May 2023. In apparent anticipation of the expiration of Vanguard's patent, another applicant, Perpetual U.S. Services, LLC, filed in February 2023 an application for exemptive relief that, similar to the Application, requests permission to create an actively managed, ETF share class of an open-end registered investment company that is not exchange-traded.[7] As of this writing, the Perpetual Application remains under SEC review.

In the 2019 adopting release for the ETF Rule,[8] the SEC provided additional color regarding its decision to exclude from the scope of the ETF Rule any relief from Sections 18(f)(1) and 18(i) of the 1940 Act. The SEC cited concerns about potential discrimination between shareholders that may result when an ETF share class and non-ETF share class exist within the same open-end registered investment company. In particular, the SEC observed that an ETF share class that transacts on an in-kind basis with authorized participants might give rise to different portfolio costs (*e.g.*, differing brokerage costs, cash drag, amounts distributable capital gains, etc.) than would a non-ETF share class that transacts with shareholders on a cash basis, which difference in costs would then be borne by all shareholders, even those that do not hold the specific share class giving rise to such costs (meaning that the holders of the ETF share class would in effect be "cross-subsidizing" shareholders of the non-ETF share class). Similarly, an ETF share class may give rise to certain unique tax efficiencies by virtue of its use of in-kind creations and redemptions, which tax efficiencies would then generally accrue to the benefit of all shareholders, including those of the non-ETF class.

The Application

Dimensional's Application seeks to obtain and expand the exemptive relief previously obtained by Vanguard by extending that relief to certain of Dimensional's actively managed open-end investment companies, in addition to its passively managed funds. The Application argues that the simultaneous offering of both an ETF share class and non-ETF share class within the same actively managed open-end fund structure would benefit all shareholders by enabling individual investors to select the manner in which they wish to hold fund interests based on the share class characteristics that are the most important to that particular investor. Among other benefits, Dimensional notes that the proposed ETF multi-class structure would in particular benefit shareholders of the ETF class to the extent the additional cash flows and economies of scale made available to the fund through its non-ETF share class could be used to facilitate portfolio rebalancing, promote smaller spreads on the ETF class's shares in the secondary market, and lead to overall cost efficiencies.

With respect to the cross-subsidization-related concerns articulated by the SEC in the 2019 adopting release, the Application proposes that these and other factors be incorporated into a board oversight regimen, under which certain specific board determinations would be required before a given fund could offer both an ETF share class and a non-ETF share class. Dimensional's Application includes a number of proposed conditions that are intended to be responsive to the SEC's concerns, including, among others, that:

- both initially before launching any ETF share class and periodically thereafter, the board of directors of a given fund must find that the multi-class structure is in the best interests of each ETF share class and each non-ETF share class individually, as well as of the fund as a whole;
- the board of directors periodically receive and evaluate certain information and written reports from the fund's investment adviser regarding the appropriateness of the ETF share class in light of the fund's particular circumstances, such as its operating history, portfolio turnover and brokerage costs; and
- any fund which offers an ETF share class in reliance on the relief include appropriate disclosure in its registration statement regarding the key characteristics of and risks associated with the multi-class structure, including an express acknowledgement that potential transactions through one share class might generate portfolio transaction costs or tax consequences for shareholders in

other classes.

The Application also delineates a number of additional disclosure and education-related steps that Dimensional proposes to take in order to help investors to clearly understand the differences between any ETF share class and non-ETF share class of the same fund.

To date, the Application remains under SEC review.

Key Takeaways

- According to data from the Investment Company Institute, ETFs' amount of assets has grown significantly in the past decade and their popularity among investors continues to grow.
- While the SEC has not granted similar relief in the past since Vanguard, if the SEC opts to do so now, it could provide opportunities for other mutual fund complexes to seek similar relief. Asset managers that are interested in offering ETF share classes within an existing mutual fund structure may want to consider filing their own application for exemptive relief with the SEC to the extent the SEC ultimately grants the exemptive relief sought in Dimensional's Application.
- The conditions offered by Dimensional will place additional burdens on directors. The Application (which someday will likely be codified in Rule 6c-11) is, perhaps, an example of how board responsibilities proliferate.

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[1] *See* Dimensional Investment Group Inc, DFA Investment Dimensions Group Inc, Dimensional Fund Advisors LP, File No. 812-15484 (July 13, 2023) (application) (available here).

[2] *See* Vanguard Index Funds, Investment Company Act Release Nos. 24680 (Oct. 6, 2000) (notice) and 24789 (Dec. 12, 2000) (order); Vanguard Index Funds, Release Nos. IC-26282 (Dec. 2, 2003) (notice) and IC-26317 (Dec. 29, 2003) (order); Vanguard International Equity Index Funds, Release Nos. IC-26246 (Nov. 3, 2003) (notice) and IC-26281 (Dec. 1, 2003) (order); Vanguard Bond Index Funds, Release Nos. IC-27750 (Mar. 9, 2007) (notice) and IC-27773 (Apr. 25, 2007) (order).

[3] *See* Method for implementing an investment company that issues a class of conventional shares and a class of exchange-traded shares in the same fund, Pat. No. 6,879,964.

[4] *See* Exchange-Traded Funds, Release Nos. 33-10695; IC-33646 (Sept. 25, 2019) (the "Rule 6c-11 Adopting Release"). Other categories of ETFs which are not eligible to rely on the ETF Rule include: (1) ETFs that are organized as unit investment trusts, (2) leveraged ETFs, (3) inverse ETFs, and (4) certain ETFs which the SEC has identified as "non-transparent active" ETFs (*see, e.g.*, Precidian ETFs Trust, et al., Investment Company Act Release Nos. 33440 (Apr. 8, 2019) (notice) and 33477 (May 20, 2019) (order)). *See* Rule 6c-11 Adopting Release at 17 and 168–69.

[5] Vanguard offered a share class of its Vanguard Index Trust in order to take advantage of a license from McGraw-Hill for use of the trademark "S&P 500," which the Trust had acquired on favorable terms but which would not be available for a new fund. McGraw-Hill sought and obtained a court order enjoining it from using the S&P 500 trademark in connection with the ETF (then called Vanguard Index Participation Equity Receipts or "VIPERS"). *The McGraw-Hill Companies, Inc v. Vanguard Index Trust and The Vanguard Group, Inc.,* 139 F.Supp.2d 544 (Apr. 25, 2001).

[6] *See* The Vanguard Group, Inc., File No. 812-14287 (Oct. 9, 2015) (application).

[7] *See* Perpetual US Services, LLC d/b/a PGIA, File No. 812-15435 (Feb. 8, 2023) (application).

[8] *See* Rule 6c-11 Adopting Release, *supra* note 4.